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TECHNICAL CORRECTIONS ACT OF 1988

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 2238 and H.R. 4333

JULY 13, 1988

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TECHNICAL CORRECTIONS ACT OF 1988

WEDNESDAY, JULY 13, 1988

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:43 a.m. in Room SD-215, Dirksen Senate Office Building, the Hon. Max S. Baucus presiding.

Present: Senators Matsunaga, Moynihan, Baucus, Pryor, Riegle, Packwood, Roth, Danforth, Chafee, Wallop, and Durenberger.

[The press release announcing the hearing follows:]

[Press Release No. H-29, June, 30 1988]

BENTSEN ANNOUNCES FINANCE COMMITTEE HEARING ON THE TECHNICAL CORRECTIONS ACT OF 1988

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Thursday that the Committee on Finance will hold a hearing on tax issues now before the House that have not been previously considered by the Finance Committee. Those issues are being considered by the House Committee on Ways and Means as additions to H.R. 4333, the Technical Corrections Act of 1988.

The hearing is scheduled for *Wednesday, July 13, 1988 at 9:30 a.m.* in room SD-215 of the Dirksen Senate Office Building.

Bentsen said, "I want a technical corrections bill to pass in this Congress. To do that, the Finance Committee needs early action. Now that a House package is taking shape, it's time for our Committee to begin formal work.

"Many of the proposals that appear to be headed our way already have been before the Finance Committee, including a response to the diesel fuel tax problem, extensions of expiring provisions, and provisions making technical corrections to the 1986 Act. Other proposals may be new to our Committee, and we want to give affected individuals and businesses opportunities to comment on those," Bentsen said.

Senator Bentsen added that additional hearings on technical corrections would be scheduled if necessary.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. The hearing will come to order.

Today's hearing is on the Technical Corrections Bill, and also particularly those provisions in the House Ways and Means bill, not yet fully enacted, that this committee has not yet examined, including the Dividends Received Deduction, the Completed Contract provision, the Estate Tax Freeze provision, the Non-Discrimination provision, Section 89, and I think there is one other.

Before we get to that, though, I would like to just note that the committee is very honored with what happened yesterday to our Chairman. Because of that incident, he is not here. I also found out, and you may be interested to know, that eight previous members of the Finance Committee have been elected Vice President of the United States. So, the precedent is firmly established.

Senator PACKWOOD. Oh, that is a bad sign. (Laughter)

Senator BAUCUS. On that note, let us begin.

Secretary Chapoton, we are honored to have you here and anxious to hear what you have to say about all of these provisions.

Senator PACKWOOD. I guess it is the first time we have had twin brothers testifying against each other, too.

Senator BAUCUS. That is right. On the same day.

Secretary CHAPOTON. We can excuse him, because—(Laughter)

STATEMENT OF HON. O. DONALDSON CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary CHAPOTON. Thank you very much, Mr. Chairman.

I am pleased to be here to present the Treasury's views on the Technical Corrections Bill, H.R. 4333 and the other provisions that are being considered by the House Ways and Means Committee at this time.

Before I get into the specific bills, though, I would like to make a few observations, mainly about the constraints on the process that we see occurring right now.

First, we do need a Technicals bill very badly. There is very much uncertainty in the tax law. The 1986 Act left some holes to be filled. There are some uncertainties out there about various provisions that very badly need to be enacted. And furthermore, there are several circumstances under which the intent of Congress needs to be clarified, to be carried out as we see that intent was intended to be expressed in the Tax Bill. So, we very badly need a Technical Corrections Act.

At the same time, we don't think we need much more. We are very concerned that the 1986 Act, the Tax Reform Act, be given a chance to work, that there not be substantial changes in that Act before it is given a chance to work. And therefore, we would very much hope this process does not somehow develop any significant changes in that Act.

Furthermore, we have real concerns and reservations, as you know, directly from the President, about any revenue-raising measures that might grow out of this process.

The President's Budget did include one revenue-raising proposal, the extension of Medicare to State and local employees. We think that is a very appropriate change in the tax law. Right now, the Medicare fund is subject to a significant drain because so many State and local employees are already covered by Medicare through former employment or through spouses being covered, and yet they are not paying the amounts to justify their coverage. And furthermore, 25 percent of those employees cannot get coverage because they don't have that ability and they don't have a spouse or former employment.

So we think that is a very appropriate change in the tax law. It does pick up revenue, and we suggested it as a method of paying for the relief and the extension provisions that we think are appropriate.

We have also considered the other revenue-raising proposals that are contained in the House Bill, and I will comment on them. There are those in there that we could support. But I just would wish to encourage the committee that the process of raising revenue should be very limited and a great deal of consideration should be given before any additional revenue raisers are included to pay for additional extenders, and things of that sort.

The proposals that we supported extending are the R&E credit, the 861 R&E allocation, the provisions relating to the application of the 2 percent floor to mutual fund shareholders, and triple tax relief for foreign corporations with U.S. branches and U.S. shareholders.

Now, since the budget was prepared, we have become aware of this diesel fuel problem particularly as it adversely affects farmers, and we think that some relief should be provided. And of course this committee acted on that in March, and the Ways and Means Committee is considering that as well. So we strongly support that.

In addition, we think some careful consideration should be given to extending the relief provisions for S&Ls, for troubled thrifts. We would like to work with the committee on some method of accomplishing that.

But beyond those specific items, we urge the committee to go carefully and slowly, because we think that the available revenue is very limited, and it should be spent very wisely.

Let me turn now to the specific provisions that the committee asked us to address.

The first one is the proposed change in the dividends-received deduction, which is in the House bill.

Under current law, dividends are entitled to a complete or partial relief from current taxation when they are received by corporations. If they are members of an affiliated group, the relief is complete. If they are non-affiliated, there is a significant dividends-received deduction, which of course was reduced last year. But the proposal would drop the dividends-received deduction to 50 percent on portfolio dividends.

The level of the dividends-received deduction is a central issue in corporate taxation. The issue is whether the taxation of dividend income that is received directly by an individual from a corporation should differ from the taxation of dividend-income received by an individual after it is filtered through another corporation. Under present law, the fact that there is an intermediate corporate owner does not change the taxation of that dividend income to the extent the dividends-received deduction is available. We think any significant change to that system is inappropriate.

Our system does not integrate corporate and individual taxes. We considered that in the 1986 Act, and I think one day we should address that issue again. Many scholarly individuals, many at the Treasury, who have previously considered this issue think that it is ultimately the way we should go. But we are not there now.

But the mere fact that we don't have an integrated system does not in our view justify a reduction of the dividends-received deduction, that would of course result in multiple taxation of the same income within the corporate sector, and we think that that is the gist of the matter and is what is very troubling to us.

Let me just recap:

Before 1986 we had an 85 percent dividends-received deduction. In the 1986 Bill, that was reduced from 85 to 80 percent, primarily because of the reduced income tax rates and the concept that that was fair to maintain the approximate percentage of tax on intercorporate dividends that had existed before the 1986 Act.

But then in 1987 a distinction was drawn between portfolio holdings and non-portfolio holdings, and the DRD was then dropped from 80 percent to 70 percent.

The current proposal, which would drop that all the way to 50 percent, would significantly increase the differences between dividend income which flows to individuals directly and dividends which flow through corporations.

I think we need to consider that this matter be studied carefully before a change of this sort is made, and that it not being made merely for revenue considerations. It will have a number of consequences.

Number one, and probably the most significant, it will shift the current balance between equity and debt financing away from equity, requiring corporations to go significantly further to debt financing.

It will significantly impact industries such as banks and utilities, that traditionally rely on corporate shareholders and which have used preferred stock extensively because of regulatory requirements.

It will cause a drop in the market value of existing corporate stock, a significant drop in those values from the indications we are getting.

Furthermore, the revenue generated from this will primarily come from current holders of portfolio stock, because we would clearly expect that in the coming years, if this provision is adopted, corporations will adapt somehow to it, probably by increasing their debt structure, and therefore, while we see some significant revenue in the near term, the revenue in the long term would be limited because of those changes.

In summary, let me just say it this way: I think we really should step back and look at what we are doing here before we just drop this bomb in the corporate tax structure.

The DRD has been a part of this structure almost from its inception, recognizing that the mere fact that a dividend goes through several corporations should not change or significantly increase the tax on that income before it reaches the shareholder.

As I indicated, it will cause a significant drop in existing stocks, particularly preferred stocks which are held by corporations. But let me point out why I think that drop would be quite significant.

What we are doing now should not be viewed as merely an adjustment of the dividends-received deduction. All of the arguments advanced to support the reduction from 70 percent to 50 percent would justify dropping it all the way from 50 percent to zero. So I think corporate America, if this provision goes through, would have to look at it as if the DRD deduction for portfolio stock might well go to zero, and I think they are already looking at it that way with some concern.

I think, therefore, that the drop in the value in corporate stocks will take that into consideration.

More than just producing a drop in value, it would significantly change the structure, the capital structures, which corporations have relied upon for many years, for more than 50 years. And it will change their financing mechanisms, which they have relied upon in current law; it will require them to go more to individuals, I suppose, for equity money; it will require them to go to debt, in many cases, where they cannot issue equity securities.

It will particularly hurt the utilities, which as I have indicated, rely heavily on preferred stock and in many cases cannot go to debt.

It will hurt banks very significantly, which rely quite heavily on preferred stock.

Our testimony has, on page 7, some examples of data that indicate how significantly preferred stock is used. I think it is preferred stock that we are primarily talking about here.

Approximately 27 percent of some $27 billion of preferred stock issued in the years 1984 through 1987 was issued by utilities, 17.5 percent was issued by banks, and 14 percent by industrial. Utilities obviously are the biggest users of preferred stock.

So what I am saying is that I think, if something like this should be considered, it should be done in a more reasoned fashion, with studies to see where the appropriate level of the DRD should be. It should be done with some grandfathering for existing stocks out there so that it does not adversely affect the stock values so significantly; and really it simply should not be done in the context of a Technical Corrections Bill as a revenue-raising measure.

The next item covered in our testimony is the proposed elimination of the completed-contract method of accounting for long-term contracts.

As this committee knows, the completed-contract method already has been reduced. Starting in the 1986 Act, corporations otherwise eligible to use long-term contracts were able to use them only to the extent of 40 percent of their total long-term contracts. This was further reduced in the 1987 Act, so that 70 percent could not be used, and only 30 percent of the income can now qualify for the completed-contract method of accounting.

We have considerable concerns about going again to this source for revenue. I think it is an illustration of what I just said a minute ago about the DRD, though. When an argument does not stop at any given point, the tendency would be, once the argument is accepted in the legislative process, the tendency is to go all the way to eliminate that perceived tax benefit to raise revenue, because revenue in these days is very hard to find. And I think in the case of the completed-contract method of accounting this is going to far.

When the 1986 changes were made, there was some recognition of the fact that the cost capitalization rules we were adopting in 1986 would have some limitation on users of the completed-contract method of accounting and therefore it might have been appropriate to consider some changes in those rules. I do not think it was appropriate to consider them again in 1987, and the Administration does not support taking this step at the current time.

The next item in the testimony is the speed up of collection of the corporate estimated tax. This proposal is an extension, and we think an appropriate one, of something that was addressed by the committee and by Congress last year. That is, where a corporation uses a safe harbor method of paying corporate estimated taxes and uses the annualization method, for example, in one quarter but then changes to the annual income method in the next quarter, it should catch up so that it does not get a benefit from shifting from one method to another from quarter to quarter.

In 1987 the committee addressed that issue and determined that the makeup should be to the extent of 90 percent of the benefit achieved by altering from one method to the other. The proposal being considered by the Ways and Means Committee would say that the corporation, when it shifts from one method to another, has to make up 100 percent of that difference, of the benefit gained by the use of the other method in the other quarter, and we would support that proposition.

Alaska Native Corporations: This was a proposal that came in originally in 1984 but then was further expanded in 1986, the purpose of which was to allow special affiliation rules for Alaska Native Corporations to sell their losses and credits through 1991.

The proposal being considered by the Ways and Means Committee is to repeal this special affiliation rule effective April 26, 1988.

We think that this is an appropriate proposal, and we would support this proposal.

The revenue losses originally estimated for allowing Alaska Native Corporations to sell their losses and credits without the usual limitations applicable under the tax law, such as Section 269 and 382, have been far exceeded. There have been just far more losses than were anticipated.

As a tax policy matter, these provisions have always been somewhat controversial. This has been particularly so in light of the many restrictions which came in in the 1986 Act and the 1987 Act, on the ability of corporations to transfer losses.

So in view of those circumstances, we think that proposing a change or requiring a change in that provision effective April 26 is appropriate, and we would support that.

We would encourage the committee, if it agrees and does consider that matter, to clarify some of the provisions that are now in the House bill. There is some uncertainty of when the loss arises, whether it is when the loss is economically incurred or whether it is when the loss is realized or recognized. We think refinements of that sort, and perhaps some further consideration of the application of the effective date rule and the transition rule when a loss is incurred before April 26th but income is earned after April 26th.

These rules are complex. We think, by and large, they are good and accurate, but we would have some suggestions, which are discussed in the testimony, for rationalizing them somewhat, and we would be happy to work with the committee on that.

The next item listed in the testimony is Section 89, Non-Discrimination Rules.

These rules came in in the 1986 Act, and we supported them. They were Treasury-supported proposals to include in the law nondiscrimination rules for employer-provided health benefits. We supported those because we think employer plans should provide comparable health benefits to lower-paid employees, and we think it is appropriate to have fair allocation among taxpayers, both high-paid and low-paid, of the tax benefits associated with health coverage.

Section 89 is scheduled to go into effect now on January 1, 1989.

We have heard a lot from employers and from staffs on the Hill who have expressed concerns about the difficulty of proving compliance with Section 89. Employers have to collect and analyze employee family status and health coverage data, and they have to do this with respect to every day of the tax year.

We are very concerned about these complexities and the difficulties of complying with these rules. We have worked with the staffs of the Ways and Means Committee and the Joint Committee and the Senate Finance Committee concerning the changes which are proposed in the Ways and Means bill now on the table, and we think these changes are by and large appropriate, and we would support these. We would hope that they are adopted.

They would apply Section 89 by using any reasonable valuation method for the time being. We think this would give needed relief, because employers would be able to determine what a reasonable valuation method would be. They would allow statistical sampling.

By and large, we think these changes are appropriate. We think, if adopted in the fashion proposed, they would give significant relief to employers, significant relief which we think is necessary. But we think with these changes, and with our continued efforts to get out guidance in the form of regulations as soon as possible, Section 89 will work, and we would urge that no change be made in the effective date of January 1, 1989.

On this related subject, there is one issue that is not addressed in the Technical Corrections Bill in the Section 89 provisions, which I would like to just comment on, because we have gotten a lot of inquiries and know business is worried about it. It is discussed in the testimony in detail. There is concern about whether under Section 89 there will be a separate line of businesses or operating units recognition. In other words, whether, when a large corporation has separate businesses and operating units in various parts of the country, it can disaggregate those business units for the purposes of making the valuation calculations and the non-discrimination rules under Section 89.

We plan to issue guidance at a very early date to say that employers can disaggregate. We think that will significantly give guidance to employers in this regard and, I think, give them the relief which we think is appropriate.

The next item in the testimony is the extension of the Low-Income Housing Tax Credit.

This credit does not expire until 1990. And in part for that reason, we would oppose taking any action to extend it at the present time.

The Ways and Means Committee proposes to extend it for one year. We think that instead of extending it now, it should be reviewed and studied for another year, and action to determine whether or not to extend it and whether or not it should be changed should be taken a year from now, to determine if the credit is working properly or if it is not working properly, or how it needs to be changed.

We have some considerable reservations about the credit that are touched on in the testimony: Whether some of the subsidized units that are being built are simply replacing units that would be available in the absence of this federal assistance; the fact that the credit includes no incentive for maintenance, and therefore it would allow units to deteriorate, which we think could be very detrimental to the overall low-income housing situation.

We have some concern whether, without continued economic incentive in the future, owners will continue to rent to low-income tenants, and whether that point should be clarified; and, furthermore, just whether the program is sufficiently efficient or whether more reliance should be placed upon the Administration's efforts to use rental housing vouchers to help low-income individuals have appropriate housing.

So we think all of these questions should be considered before the committee or the Congress acts to extend the present Low-Income Housing Tax Credit.

The final point that I have been asked to speak to this morning relates to the Estate Tax Freeze provisions, Section 2036(c).

The Estate Tax Freeze rules came into law in the 1987 Act. They removed various advantages of the so-called "Estate Tax Freeze," whereby taxpayers were using a mix of corporate and common stock or, in partnerships, preferred interests versus so-called "common interests" in partnerships to attempt to transfer to lineal descendants or others in their family a valuation or future growth in value in the business entity.

We had some concern about those provisions when they were enacted in the 1987 Act. There are tax policy arguments to support some of the changes, but our concern really went more to the point that this was a further increase of tax on estates.

There were other proposals to increase taxes on estates that were adopted in the 1986 Act—phasing out the rate schedule, holding the tax rate at 55 percent rather than allowing it to drop to 50 percent as it was intended to do—and therefore we would suggest that these provisions be carefully studied and further tighteners of these Estate Tax Freeze provisions be implemented only to the extent deemed absolutely necessary.

Primarily for that reason, because it does impose additional tax, as we see it, on estates, there are provisions that we recognize are really necessary that need some attention, that the rules simply need some clarification, such as when debt might be used so to not violate the estate tax free rules, or when bonafide buy-sell arrangements might be appropriate, and things of that sort.

So we would like to work with the committee on making those changes, and we do go into some detail in our testimony. But we would suggest that the committee not adopt all of the tightener provisions, because of the reasons I have outlined.

One final point that I would like to address and have touched on in my testimony and that I have testified on before this committee, just about a year ago, and that is the provision in the Technical Corrections Bill now before the House and in this Senate Finance Committee on Residual Treaty Overrides.

I have expressed my concern about this a number of times, and I simply want to reiterate my concern and make a few additional observations.

We have been working closely with the Joint Committee staffs and the staffs of Ways and Means and Finance in trying to determine what would be appropriate with respect to the Residual Treaty Override, because we simply think that as it is currently proposed in the bills it is not properly justified and should not be enacted.

As I have indicated in prior testimony, this provision significantly hurts our relationships with our foreign trading partners. They simply cannot understand why, when we enter into bilateral treaty negotiations, which treaties are subsequently ratified and approved by the Senate, that without going back to bilateral negotiations the Congress would see fit to override treaty provisions by a statute.

Now, we do recognize that there are some concerns that some individuals take unwarranted use of treaty provisions to get around legislative provisions that this Congress enacts, and we are worried about that, and we would like to work with the Congress.

As I say, we have worked with staffs, and we think we are developing proposals that would address these concerns, but still not have the residual treaty override which so adversely affects our relationships. It would set out rules for interpretation between treaties and statutes, which we think would be a much more beneficial way of approaching this issue.

Senator BAUCUS. Mr. Secretary, I am going to have to interrupt you here. The vote is on now, at this moment.

The committee will temporarily recess until either Senator Moynihan or perhaps Senator Pryor returns, then we will immediately resume.

Thank you very much.

[Whereupon, at 10:12 am., the hearing was recessed.]

AFTER RECESS (10:20 a.m.)

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. I wonder if I might ask our guests to quiet down. We are sorry the hearing was interrupted by a vote, but that is what we do here.

Mr. Secretary, have you completed your formal testimony, sir? Or would you like to add some further remarks?

Secretary CHAPOTON. No, Senator, I have finished. I was right at the end of it when the vote broke. I might have had another sentence or two, but I will let that go.

Senator MOYNIHAN. Well, you are always welcome here. You don't always bring welcome news, but you are always welcome here. (Laughter)

Secretary CHAPOTON. Well, thank you. That completes my statement, and of course it goes into much more detail in the testimony, which we worked very hard on and would invite the committee's attention to.

Senator MOYNIHAN. It is very detailed testimony, and we appreciate that.

I know that Senators will want to send you some written questions. Senator Packwood, in particular, may wish to do.

And then, for the moment, Senator Danforth?

OPENING STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM MISSOURI

Senator **Danforth**. Thank you very much.

Don, I have previously expressed the thought that, when I pass to my reward, I hope I know where I will be going.

Senator **Moynihan**. Well, if you don't, who does? (Laughter)

Senator **Danforth**. Well, you and I might have different opinions on it, Senator Moynihan.

Senator **Moynihan**. Well, thank you, Your Grace.

Senator **Danforth**. I have this mental image of St. Peter greeting me at the pearly gates and saying, "What did you do with your life?" I will answer, "I have done my best to save something called The Completed-Contract Method of Accounting." (Laughter)

But I have a feeling that my death is more at hand than it used to be on this particular subject.

Don, first of all, can you explain to us in very simple, comprehensible language what the percentage-of-completion method does with respect to long-term contracts? Maybe give us a little example of how it works.

Let me just say how I understand it works:

My understanding is that you can have, say, an aerospace company and enter into a long-term contract for the delivery of say 100 airplanes. Those planes will be delivered beginning maybe five years from now, and then they will be delivered over the next five years.

The contractor gets paid as the planes are delivered, but typically there is the retainer; typically they are paid about 75 percent until the end, and then there is a balloon at the end of the contract. In other words, payment under the contract, a very expensive contract, typically balloons out very late, a number of years down the road.

On the other hand, the costs of the contract are often incurred very early, including the cost of preparing the bid itself, the cost of the research, and so on, before anything is delivered, before there is any payment, before there is any contractual obligation to make a payment.

Now, it is my understanding that under the percentage-of-completion method, the contractor begins recognizing income at the very early stages, even while he is preparing his bid for the contract.

Is that a fair statement?

Secretary **Chapoton**. Senator, he begins recognizing earlier; when he incurs costs, that is when he begins recognizing income.

The percentage-of-completion method, in simple terms, is that you take into income a pro-data share of the total contract price at the time costs are incurred, rather than at the time you receive income.

Senator **Danforth**. Isn't it correct that these long-term contracts typically incur costs that are front-loaded, and the full payment tends to be at the very end of the contract?

Secretary **Chapoton**. Certainly the payments, as you indicated, are something less than 100 percent of a pro-rata payment. So, yes, the costs are earlier and the payments are later.

Senator **Danforth**. Now, the completed-contract method, by contrast, that is the old completed-contract method before 1982 provided that the income was not recognized until the end of the contract, right?

Secretary **Chapoton**. That is right.

Senator **Danforth**. And that was subject to abuse, because contractors could put off the final act, and in fact they would be paid, but the payments wouldn't be recognized as income until the end of the contract. That was the abuse, correct?

Secretary **Chapoton**. Correct.

Senator **Danforth**. And so it was true at that time that defense contractors, aerospace contractors, could have a very substantial forward pass, and yet not be paying taxes on it, and it was widely publicized as an abuse, right?

Secretary **Chapoton**. That is correct.

Senator **Danforth**. So we began in 1982 to correct this situation, first to change abuses in the system and then to start chipping away at the percentage of the contract that could be subject to the completed-contract method, right?

Secretary **Chapoton**. That is correct.

Senator **Danforth**. Now, the question is, as you pointed out in your testimony, where do you stop on this continuum that turns something that is an abuse into something that is fair, and then into something that is no longer fair because it is an excessive tax on money that isn't received and on a contract that isn't even finished yet, and there are no obligations that have been incurred under the contract yet by the recipient of, say, the aircraft?

Right now, under current law, it is my understanding that the aerospace industry, in 1987, has an effective tax rate of 38 percent. The maximum corporate tax is 34 percent. Right?

Secretary **Chapoton**. I have seen those figures. Yes, sir.

Senator **Danforth**. Typically the effective tax rate for most corporations would be lower than the maximum tax rate, right?

Secretary **Chapoton**. Typically, yes.

Senator **Danforth**. And it would be somewhat unusual to have an effective tax rate that is 34 percent?

Secretary **Chapoton**. It is very clearly a factor of phasing out the completed-contract method of accounting.

Yes, I agree with that statement, Senator.

Senator **Danforth**. I want to put this in the record, Mr. Chairman, and ask unanimous consent to put this table in the record of Aerospace Industries Association's survey of the average effective tax rates in 1987 and 1992.

Senator **Baucus**. Without objection.

[The table appears in the appendix.]

Senator **Danforth**. But let me just read the numbers under current law, without the change that has been proposed by the Ways and Means Committee:

"In 1987, under current law, the effective tax rate for the aerospace industry is 38 percent; in 1988, 60 percent; in 1989, 41 percent; in 1990, 68 percent; in 1991, 40 percent; in 1992, 37 percent."

Under the House bill, the full elimination of this system, the effective tax rates in 1988 would go from 60 to 61 percent, in 1989 from 41 to 43 percent, in 1990 from 68 to 76 percent, in 1991 from 40 to 46 percent, in 1992 from 37 to 39 percent.

Now, Mr. Chapoton, you are appearing here as the Assistant Secretary for Tax Policy. Do you see purpose from the standpoint of tax policy to be served by the total elimination of this system?

Secretary CHAPOTON. Senator Danforth, we obviously oppose this change. We have heard all of the arguments you alluded to about the circumstances being abused in earlier years, we have looked at those concerns, and we understand those arguments.

But we think that there is clearly additional complexity in going to the percentage-of-completion method, as you pointed out. It is a cost-against-cost method, which is questionable, and we think going back to this same source for these significant revenue dollars that are involved here——

Senator DANFORTH. What is it?

Secretary CHAPOTON. It is $800 million in one year, I know, but I don't have the figures before me.

Senator DANFORTH. It is $2.4 billion.

Secretary CHAPOTON. And we think most of those costs will be filtered right back to the Defense Department, which has already had significant budget reductions as a result of last year's Budget Summit Agreement and things——

Senator DANFORTH. The industry would also presumably lose foreign sales, correct? Not that we care about that around this place, but if we did care about foreign sales?

Secretary CHAPOTON. I have not thought that through. I suppose that is appropriate. But we know it would very clearly increase the Defense Department costs in acquiring weapons and any items that need to be purchased under long-term contracts.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator BAUCUS. Senator Chafee?

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Chapoton, I wasn't here through your testimony, but you did support the extension of the R&D tax credit, did you not?

Secretary CHAPOTON. We did support that. I did not comment on it elaborately, but we do support extension of the R&E tax credit.

Senator CHAFEE. Would you have it permanent?

Secretary CHAPOTON. We would have it permanent, yes.

Senator CHAFEE. At the 20 percent?

Secretary CHAPOTON. At the 20 percent. Well, let me take that a bit further.

This was covered in more detail, Senator, in testimony yesterday.

But we would support the Danforth-Baucus Bill on that. That has a 20 percent credit with an alternative 7 percent credit. We would support it only if it does not increase the revenue cost under current law, and with that alternative credit, which we think is highly desirable because it brings in a number of companies that are engaging in research that we think should have the incentive of the incremental credit; but with that alternative 7 percent credit, it raises the revenue costs some. That would be, in our proposal and in the Danforth-Baucus Bill proposal, paid for by reducing the amount of R&E deductions to the extent of the credit.

Senator **Chafee**. What is Treasury's position on the Mortgage Revenue Bonds?

Secretary **Chapoton**. We oppose extension of the Mortgage Revenue Bond provision. We think, first, it has been an inefficient provision. We think that it simply is not working as it should be, and it is just terribly expensive.

Senator **Chafee**. Well, all the testimony we have had from every one of our housing officials in our States is contradictory to that. I don't want to belabor it here, but I know there was a report out by the GAO that said that it wasn't efficient; but that was an old report that dealt with it when there were abuses. We believe we have straightened out those abuses.

Just speaking for my own State—and I have met with the housing administrators of the other States as well—that is their number-one priority in wrestling with this lack of adequate housing.

Secretary **Chapoton**. Well, we know that. We know there is a great deal of support for that extension, and we have tried to make our case on that.

I can furnish you some more details in testimony we prepared on that point, but it does have to do with the inefficiency, the fact that a great deal of the tax benefit from the issuance of the tax-exempt bonds is filtered out before it ever reaches the intended beneficiary. It is filtered out by investment bankers or people that participate, that buy and sell the bonds, by investors in the bonds, and things of that sort. That is inherent in any tax-exempt bond to some extent, but we think it is even greater in that case.

Furthermore, a number of the people who are benefiting from this provision would be able to buy homes anyway. Now, some of the concerns that we have, such as it not taking into consideration family size, we know that has been addressed in the House bill, and we welcome those changes if it is to be extended, and some of the other concerns we have.

But even with those changes, we still have considerable concern about it as being too expensive.

Senator **Chafee**. Getting back to this completed-contract business, Boeing would fall under that, would they not? If they get a large order from the Japanese Airlines, or whatever it might be?

Secretary **Chapoton**. I would assume so, yes.

Senator **Chafee**. So wouldn't they come under this? It isn't just defense contractors, by a long shot.

Secretary **Chapoton**. Oh, no, it is not just defense contractors at all. No. But a substantial portion of the defense contractors do work under long-term contracts. I don't have percentages to what extent the total revenue comes from defense contractors, but it would be substantial.

But it does. Very clearly, it is anyone on long-term contracts.

Senator **Chafee**. Well, obviously few of us are immersed in this to the extent that the Senior Senator from Missouri is, but it does seem that we are getting into an unfairness here with the suggestions that come up of getting rid of the completed-contract method totally, and that obviously is your opinion, likewise.

Secretary **Chapoton**. That is our concern. Even if some inroads were appropriate just to change something so dramatically, so quickly, just boom, boom, boom, the 1986 Act, the 1987 Act, and now in 1988, we think is just hitting one source too often and too much.

Senator **Chafee**. Again, I am sorry I wasn't here, but as I understand it, what you said was that we should not do anything further on it this year?

Secretary **Chapoton**. That we should not do anything further on it this year, that is correct.

Senator **Chafee**. And do what? Look at it? I mean, study it?

Obviously the House has gone ahead. Have they eliminated it totally?

Secretary **Chapoton**. They have eliminated it totally in their bill. Their bill has not been finally acted on, of course; but that is where it stands now.

Senator **Chafee**. Thank you, Mr. Chairman. I may come back later.

Senator **Baucus**. Thank you.

Senator Moynihan?

Senator **Moynihan**. Mr. Chairman, we have distinguished guests arriving in one hour's time, as you know, and I suggested earlier that some of us might want to put our questions in writing.

Senator **Baucus**. Thank you very much, Senator. You are correct: the presidential nominee will be visiting us at 11:45 today, so I remind all committee members to try to keep their questions short.

Senator **Chafee**. We will quit in an hour, here, is that it?

Senator **Baucus**. An hour and 10 minutes. That is right.

OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator **Durenberger**. Are we invited to keep our questions brief, or are we invited to this 11:45——

Senator **Baucus**. That is your choice, Senator.

Senator **Durenberger**. Either one? Where is the meeting?

Senator **Baucus**. Well, the Democrats are meeting with Governor Dukakis. (Laughter)

Senator **Durenberger**. That doesn't sound like an invitation to this side of the table. (Laughter)

Senator **Moynihan**. What are the possibilities of a joint nomination? Now, that would be a new move in American politics. (Laughter)

Whoever you got as President, you would know who you were going to get as Vice President. Think it over.

Senator **Baucus**. Well, there is New York precedent for that, in New York politics. That is right.

Senator **Chafee**. You fellows are just trying to move up the ladder on that side over there. (Laughter)

Senator **Pryor**. I heard Senator Matsunaga say he had a lot of new friends yesterday. (Laughter)

Senator **Baucus**. Senator Durenberger?

Senator **Durenberger**. Mr. Chapoton, let me just explore the issue of the inefficiencies in tax policy in housing. I don't know if you are an expert on it. I presume you are, since you are responsible for Administration views.

I heard your reaction to John Chafee's question on Mortgage Revenue Bond financing. You said it is inefficient, and then you followed up by saying that a lot of money went to folks that are involved in helping capitalize the project, and so forth.

I just sold my home in McLean and bought another one, and I noticed a lot of people made money off of my tax subsidy, including me. I mean, I made a big chunk of money that I have been able to pocket, like every other American, from something called the Mortgage Interest Deduction. But then, a lot of other people made it on me, too.

Let us say, theoretically, my house doubled in value during my tenure here in the United States Senate. That means what I got out of the subsidy by way of savings or investment potential has substantially increased. What my realtor made on his or her 6 percent commission and what my mortgage company made on their little investment in my mortgage keeps going up as well.

And I suppose if I totalled all of that up for all Americans, it would amount to a huge tax subsidy plus a lot of what some people might say is extraneous benefit.

Yet in this country, at least where I come from, we have a lot of low-moderate income folks who cannot afford housing off the mortgage interest subsidy all by itself. We have a whole generation of our children coming online who can't afford the rent on a house.

So I guess my question to you is, would you compare the so-called "inefficiencies" of MRBs with all the other subsidies that we currently employ in the Tax Code and tell me why MRBs, targeted, are more inefficient than say the Mortgage Interest Deduction and the Real Estate Deduction, and all the rest of those tax policies?

Secretary **Chapoton**. Well, I would give it a try. I think, first, to say that I am an expert in the area might stretch it somewhat. We have testified on it several times. Frankly, I have not come today prepared to discuss that in detail; but I am generally familiar with the area.

There are clearly incentives, and not necessarily the totally efficient incentives that you talk about in the present Home Mortgage Interest Deduction Rule.

It is a little difficult to compare those with the Mortgage Subsidy Bonds, because they are so different. But we have concern all the time about tax-exempt bonds, but some of the points I made would really go to all tax-exempt bonds. And I think we could get into that debate—when tax-exempt bonds are good, and when they are inefficient, and compare them with other tax incentives—and that would be a drawn-out debate.

I think my main concern with the mortgage revenue bonds is that it is not sufficiently targeted.

Now, the House bill does target it more. It changes some of the income provisions, the median income provisions that must be met.

As I indicated, it affects the family size—it tries to aim at the family size—and it reduces the benefits somewhat based on the income scale of a particular recipient, or the beneficiary of it.

But we still have indications that a substantial portion of the benefits go to people that would have been able to afford homes anyway, simply with the interest-deduction subsidy, the interest-deduction benefit that you made reference to. And that is one of the inefficiencies.

When I talk about "inefficiencies," I am not talking just about those that affect all tax-exempt bonds; I am talking about the fact that people who would buy homes—who would be able to afford to buy homes, and are already getting significant tax subsidies or incentives through the interest deduction—are benefiting here, and therefore they get that double benefit. We think that is simply spending the government's money a little bit unwisely.

Senator Durenberger Well, you know each of us deals from our own sense of experience. But I come from a community in which the conclusion that you arrived at and GAO arrived at with regard to other options people have just isn't true. And the Mortgage Revenue Bond is used for those who do not have other alternatives, because in the market those alternatives don't exist.

I read the GAO report, and it said, "You are encouraging $60,000 homes when people should be in $40,000 or $50,000 homes." Well, there aren't any $40,000 or $50,000 homes in, say, a metropolitan area. There only are $60,000 homes, and most of these people can't get at them without this subsidy.

So I would love to, and I think we are going to have to beginning next year, get into an extensive debate of the whole issue of efficiency of these subsidies as we talk about tax-exempt bond financing. And I think the efficiencies is a good place to start.

Secretary **Chapoton**. We would be happy to work with you on that. Some of the changes in the Ways and Means Bill are clearly in the right direction, if it is to be extended, and we certainly would like to work with you in improving its efficiency and making it more targeted. So we would be happy to have that discussion.

Senator **Durenberger**. Thank you, Mr. Chairman.

Senator **Baucus**. Senator Matsunaga?

OPENING STATEMENT OF HON. SPARK M. MATSUNAGA, A U.S. SENATOR FROM HAWAII

Senator **Matsunaga**. Thank you, Mr. Chairman.

Mr. Chapoton, for almost 2 years, since the passage of the Tax Reform Act of 1986, individuals and businesses have had to operate under tax rules which in many cases were inconsistent with the intent of Congress.

Now, we tried to remedy the situation by trying to include the Technical Corrections Act in the Budget Reconciliation Act, but the Administration opposed it.

But last December, you will recall, Secretary Baker assured that passage of the Technical Corrections Act would be given a high priority.

Now, has that position remained the same? Will the Administration give full support to passage of the Technical Corrections Act this session of the Congress?

Secretary **Chapoton**. Absolutely, Senator Matsunaga. We strongly support it. We think we urgently need this Technical Corrections Act. And I agree with your comments, that it has been two years since the 1986 Act was enacted, that in a number of ways the intent of Congress is being frustrated by technical inaccuracies or just confusion on some provisions that need to be clarified.

That is why we are urging that this bill not be used for broader revenue-raising purposes or broad extension purposes, or other tax-losing measures that will simply jeopardize its passage—slow it down at the very least, and possibly jeopardize its passage.

I think the main focus should be upon getting the Technical Corrections Bill into law, and we strongly support it, and Secretary Baker very strongly supports that proposal.

Senator **Matsunaga**. Mr. Chairman, I have other questions, but in the interest of time, since there are other members here to ask questions, I will submit those questions in writing, to which I ask that the Secretary respond.

Secretary **Chapoton**. We will be happy to, Senator.

Senator **Moynihan**. Mr. Chairman, I am just informed that the Committee on Foreign Relations has to have one other person for a quorum. It will be our last business meeting of the year. We have ambassadors that have to be confirmed. If you would excuse me?

And if I could ask Mr. O'Brien and Mr. Graziano to excuse me? I look forward to their testimony. I certainly will read it.

Senator **Baucus**. Senator Packwood?

Senator **Packwood**. Mr. Secretary, it was not in your testimony in chief, and if the question has been asked I apologize. This is on employer-paid education. Were you quizzed on this while I have been gone?

Secretary **Chapoton**. No, sir, I have not been.

Senator **Packwood**. Is Treasury's opposition to it fiscal, or philosophical, or both?

Secretary **Chapoton**. Well, I wouldn't say it is fiscal. I wouldn't quite go so far, though, as to say it is totally philosophical. It relates in part to the comments I was making about mortgage revenue bonds, but for entirely different reasons, and that is that it is poorly targeted toward low-income taxpayers.

Senator **Packwood**. It is—say that again?

Secretary **Chapoton**. Poorly targeted toward lower-income taxpayers. It is spending government money, the tax subsidy, on many higher-income individuals.

Senator **Packwood**. Okay.

Secretary **Chapoton**. The subsidy, the benefit of employer-paid education, by definition, is available only to those whose employers make plans available. It is available only to those who are employed, for starters.

We think that if a tax benefit is to be given for seeking employment or improving one's ability, where under the current law you get a tax deduction for improving your abilities at your current job—you do not get a tax deduction for an education to qualify you for a new job, but the employer aid to education is not so limited—it can clearly do that.

And we know there are many worthwhile examples that do occur, that people are educated and go on to higher-paying jobs, and there is benefit from it. But it is by and large used by higher-income taxpayers, and it gives them a benefit to qualify for a higher-paying job, when the tax law generally doesn't allow that benefit.

It just seems to us that if the law is to be that there should be a tax benefit for going to school for getting a higher-paying job, why not have that apply to all who pay for it themselves?

Senator PACKWOOD. Let me ask you about your study. Who did this study? Because I think your conclusions are flawed. But who did it?

Secretary CHAPOTON. It was done in my office, under the Office of Tax Analysis.

Senator PACKWOOD. Oh well, that speaks for itself, then. I understand. (Laughter)

I will make you this bet, Mr. Secretary, that the bulk of employer-paid education in terms of cost does not go to higher-paid employees. It does go to employees, and I suppose, perforce, people who work make more money than people who don't work; but I will bet you the bulk of it goes to middle and lower-income employees.

And if your complaint is about targeting—and that is why I asked you—it is my understanding the House is attempting to target this. I haven't yet found out exactly how, but they are attempting to target it to lower-income employees. That should remove the bulk of your objection, shouldn't it?

Secretary CHAPOTON. Well, if it were clearly more targeted to lower-paid employees, that would eliminate that objection.

It is, though, difficult to see why the benefit should be denied those who don't have employers who have such plans, or don't have a job at all, and they want to go to school to get a good job, or to get a better job than the job they had last time.

Senator PACKWOOD. But on that argument, we should not allow health benefits to be tax-free. Some employers provide them, some employers don't. Why should the employees of employers that have a health plan benefit over employees of employers who don't?

Secretary CHAPOTON. That is correct. You can extend that argument too far. I concede that point. And just because it doesn't reach everyone, if it is very properly targeted, there is certainly a good argument for having it, because those plans can be affected.

Senator PACKWOOD. If you target it, frankly, Mr. Secretary, what you go back to is the old law. If you are a Vice President of General Motors, you can go to Harvard for a year or, to Brookings for two weeks, or to AEI for two weeks, and say, "This is to make me a better employee in my job." That, therefore, becomes tax-exempt. There is almost no kind of education for a vice president that you couldn't make a case for: "This training will make you better in your job."

But you take the 18 year old girl or guy that has dropped out of high school, and they are working for Tektronix or Mentor Graphics in Portland, and they say, "Listen, we will help you get a GED, and that will let you move from the tool crib to something else, and you will go to Portland Community College to do it," that moves you up in the job scale. And what you are saying is those people ought to be taxed. That isn't fair.

Secretary CHAPOTON. No, what I am saying is, if we ought to have tax incentives to move up in the job scale, there is a good argument to be made that we ought to say those expenses are deductible.

If I work for a company that does not have such a plan, and I pay for it myself, you can make the very same argument you just made and say I should get a deduction for doing that.

Senator PACKWOOD. But that gets back into the argument about how far do you go.

Secretary CHAPOTON. That is true.

Senator PACKWOOD. We used to do that when individuals provided their own health insurance. They got a deduction, as I recall, of up to $150 or $300—I can't remember which—per year. And we got rid of that.

If you want to carry the logic all the way through, I might agree with you—I don't know what the cost would be if you allowed the deduction in addition.

Secretary CHAPOTON. The cost would be astronomical. I agree.

Senator PACKWOOD. I think so, especially if you carried it philosophically through to all fringe benefits that you provide, that other employers provide you for nothing.

Secretary CHAPOTON. That is correct. That is a problem, I agree with you. And I share some of your frustrations about it. I mean, you can't do everything that we would say you ought to do, so are we saying you should do nothing? I think that is one point you are urging on me, and I understand that point.

If it is more targeted, if we actually had this benefit, I can see your arguments in favor of it. But we do think it still denies these tax incentives of some sort to non-employed people, and that still gives us somewhat of a problem.

Senator PACKWOOD. We somewhat targeted it 2 years ago when we limited it, as I recall, to $5,250.

Secretary CHAPOTON. That is right.

Senator PACKWOOD. So at least you can't have your full tuition for a Harvard MBA paid for by your employer totally tax-free.

Secretary CHAPOTON. That is right.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you.

Senator Pryor?

OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS

Senator PRYOR. Thank you, Mr.Chairman.

Mr. Chapoton, 2 years ago in the 1986 Tax Bill there was a Section 89, and that of course related to the benefits to employees. In that section the congress in its wisdom, I think, delayed the effective date of Section 89 until the Treasury Department had an opportunity draft regulations and guidelines that would show business people, what the rules of the game were going to be.

Two years later, Treasury has adopted no guidelines and no regulations. I cannot explain that to especially the small business community in my State, nor any business person, any company. And here we are, 6 months before the implementation of Section 89, with no regulations and no guidelines.

I find this inexcusable, and I wonder if you have an explanation?

Secretary **Chapoton**. Well, Senator, our testimony in main does address this concern, and we understand your frustration on it.

There are a number of concerns that have been expressed by employers. We are very sympathetic to those concerns. One is just keeping the mass of statistical information to make the calculations, the evaluation calculations, that need to be made.

What we are supporting, there are really two aspects: The regulations deal with mechanically complying with the rules; and the other, the valuation, how you make these valuation calculations.

We will not be able to get these valuation regulations out inside of 12 months. We have been working very hard on them. They are simply very complex and very detailed. So for that reason, we are supporting the proposed change in the Ways and Means Bill which would say that an employer can use any reasonable valuation method. We think that is fair. We think that in other areas, the fringe benefit area, there are valuation procedures they use that we think are very—

Senator **Pryor**. Why don't we do something, Mr. Chapoton, that is not only fair but simple, and that is extend the effective date? That is something we can all understand.

How would you advise a small business person out there to react to what we are doing here? How do they make any plans 6 months before this legislation is going to be implemented?

Secretary **Chapoton**. Well, I would have to confess to you, when I first started really hearing all the problems that were developing in this area some 4 or 5 months ago, that was my reaction, too, "Why don't we just extend it?"

When we look into it further, I think these provisions in the changes in the bill do address most of the concerns. We will be able to get out some guidance in the mechanical side of things, coupled with the changes that are made, which I think will be very effective.

The Congress thought—and we certainly agree with them, and we support it—that some anti-discrimination rules in the health care area were very appropriate. And if we can eliminate these complexities, as a policy matter, to go ahead and enforce, to have some guidance here.

Senator **Pryor**. All right. Let us assume for a moment that we might have a Technical Corrections Bill—I underline "might"—and let us say we leave here October 8th, and that is the last thing we do. That gives October, November, December for the American business people to come to grips with the guidelines and with the regulations of this new law that will be implemented January 1, 1989. That is not enough time. Even if we do it in Technical Corrections, that is not enough time.

If I might, Mr. Chairman—I don't want to overuse my time—I would like to submit for the record two studies just completed on the issue of small businesses, and how Section 89 is impacting them, especially with regard to no guidelines, no regulations; also, a recent study by the National Rural Electric Cooperative Association, a study done in June of this year on Rural Health Care. If I might put those in the record at the appropriate place, Mr. Chairman, I would appreciate it.

Excuse me, Mr. Chapoton.

Senator BAUCUS. Without objection.

[The two studies appear in the appendix.]

Secretary CHAPOTON. I would be happy to review those.

Senator PRYOR. Why don't you just support an extension and just give these people a breather? There will be a new Administration, and we can re-look at this in January. But we have got to give some relief and guidance and help to these people out here.

Secretary CHAPOTON. We will certainly look at the data. And as I say, we seriously considered and studied the merits of an extension. I truly feel, based upon these changes that are being proposed by this bill, that if they don't come into place maybe we would have to rethink the thing.

But if they do come into place, with the regulation and guidance that we know we will be able to get out on a timely basis, I mean within a couple of months, based upon these, then I would think it would not be that difficult.

Now, the rules? Employers are going to have some difficulty with them, simply because it adopts new policies, anti-discrimination policies. And for that reason alone, there is going to be some resistance to them. But we think those policies are worthwhile.

Senator PRYOR. I think, for once around here, we have an opportunity to do something for the small business people, and I think we ought to take advantage of that opportunity.

Thank you, sir.

Senator BAUCUS. Mr. Secretary, I want to thank you for your testimony and also for your emphasis at the very beginning that this be not a purely clean Technicals Bill, but that the emphasis and direction of this bill should be to make it as clean as we possibly can, and to avoid raising a lot of revenue.

I don't think this committee is very anxious to raise a lot of revenue this year. I have also noticed from your testimony that Treasury is not anxious to raise a lot of revenue.

Secretary CHAPOTON. As I understand it, the provisions that Treasury does support do raise revenue over a three-year period: the Alaska Native Claims provision for about $.8 billion, and the Estimated Corporate Tax speed-up which is about $.9 billion, and the single-premium life provision which, depending on how it works out, is about $.3 billion, for a grand total of about $2 billion over 3 years.

As I also understand it, the revenue-losers that Treasury supports over a 3-year period are the R&D Tax Credit, to make that permanent, is about $2.2 billion; the 861 Credit Allocation is about $2.4 billion; the 2-percent floor provision is about $1.5 billion; the Diesel Tax, $.4 billion; S&L extender, $.6 billion; and the Foreign Triple-tax Provision is about $.2 billion; for a total of about $7.3 billion.

That leaves about a $4.7 billion shortfall over 3 years; although the administration would like to have enacted a State and local Medicare provision, which raises a significant amount of revenue.

I am just encouraging the administration and the committee to be circumspect this year and not try to enact a lot of provisions that, first, are not necessary this year; and, second, which are just not practical, for other reasons, to enact this year.

But to the degree that there are provisions that do make sense—and there are many that do make sense—that we try to find ways to raise revenue in a way that takes care of their money.

I have in mind as a possible candidate maybe a more creative way to address the dividends received deduction provision.

You yourself, Mr. Secretary, have said that there are some abuses in the area—not "abuses," but that perhaps the provision could be better targeted to get at some questions in that area, the dividends received deduction provision.

We don't have time to go into those now, but I urge all of us to look for ways to try to pay for the research and development credit provision and others that I think should be enacted this year.

I have no further questions. Are there any other questions? (No response)

Senator BAUCUS. Thank you very much, Mr. Chapoton.

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator BAUCUS. In the interest of time, I would like to ask the remaining witnesses to shorten their testimony. I apologize to all the witnesses, but the members of the committee are very verbose and take a lot of time.

But I ask the remaining witnesses to please shorten their testimony.

The first panel will be John O'Brien, Chief Executive Officer of Grumman; Mr. Dale Stuard, President of the National Association of Home Builders; and Mr. Glenn Graff, who is the Executive Vice President and Chief Financial Officer of Linbeck Construction Company.

I know each of you earlier had been advised that you will have five minutes. I regret that I am going to have to cut that down to two minutes, two minutes each, and I also urge the same constraint upon members of the committee.

Again, just to remind everyone on the committee, the reason for the constraint is that Governor Dukakis will be meeting with Democratic members of the Senate at 11:45. That is why we have to constrain this meeting.

Mr. O'Brien, why don't you begin?

STATEMENT OF JOHN O'BRIEN, CHIEF EXECUTIVE OFFICER, GRUMMAN CORPORATION, AND CHAIRMAN, TAX COMMITTEE, AEROSPACE INDUSTRIES ASSOCIATION, BETHPAGE, NY

Mr. O'BRIEN. Thank you, Mr. Chairman.

The aerospace industry is a major source of U.S. employment, the producer of a solid trade surplus, and a significant contributor to our national defense and our standard of living.

Since 1982, changes in the method of accounting for long-term contracts have increased the taxes of the aerospace industry dramatically. These changes are expected to raise almost $40 billion from 1982 through 1992, by accelerating taxes paid by long-term contractors. A survey of 11 major aerospace companies shows their average effective tax rate is expected to be 60 percent in 1988.

The Ways and Means Committee has proposed a further acceleration of tax payments by the imposition of the 100 percent percentage-of-completion method and the repeal of the completed-contract method.

The cost-to-cost percentage-of-completion method currently used to report 70 percent of the income from a long-term contract is neither a proper nor a fair system of taxation. Cost-to-cost percent age of completion taxes profits before they are earned; that is, before payment is received, before a right to income accrues under the contract, and before financial income is reported.

These proposed tax changes would impose an unfair system of taxation on long-term contracts, create serious cash flow problems for the industry, and adversely affect the ability of the industry to produce more jobs, to contribute even more in fighting the nation's trade deficit, and to make the technological breakthroughs that will strengthen our national defense and improve our standard of living.

We ask this committee to consider the serious flaws in the cost-to-cost percentage-of-completion method and to substitute a new system of accounting for long-term contracts that is fair and consistent with the tax accounting system of other U.S. manufacturers.

Thank you, Mr. Chairman.

[The prepared statement of Mr. O'Brien appears in the appendix.]

Senator BAUCUS. Thank you very much, Mr. O'Brien, particularly for shortening up that statement and also giving such an articulate 2-minute statement.

Mr. Stuard?

STATEMENT OF DALE STUARD, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, NEWPORT BEACH, CA

Mr. STUARD. Mr. Chairman, my name is Dale Stuard. I am a builder from Newport Beach, California, and currently the President of the National Association of Home Builders.

I have submitted a written statement, so I will direct my concerns today to remarks concerning the Ways and Means Committee's decision to require the percentage-of-completion contract accounting method for long-term contracts.

Additionally, the IRS has recently announced, in Advance Notice 88-66, its position that a home builder will be subject to long-term accounting rules with respect to any home that has a sales contract on it and is under construction at the end of the taxable year. We believe that this position of the IRS is flawed, for several reasons.

Except for some very limited parts of the installment sales rules, no other provision of the Tax Code requires payment of taxes prior to having bookable, recognizable profits. Builders are unable to book profits on homes under construction for the following reasons:

Funds are received in escrow until closing and are not for the benefit of the builder.

Two, the buyer has the ability to withdraw from the sale virtually any time prior to the closing of the sale; and

Finally, the builder retains title to the property until closing.

So, for these reasons, FASB has not allowed builders to book profits on these transactions. To require home builders to report on a percentage-of-completion basis would impose an extremely unfair and unjust hardship.

Under general rules of accrual accounting, income is included for the taxable year when all events have occurred which fix the right to receive such income and the amount thereof, can be determined with reasonable accuracy. It would be difficult to meet this test, when as many as 25 to 30 percent of the builders' sales contracts may be canceled prior to the ultimate closing of that sale.

Additionally, accounting on a percentage-of-completion method would be administratively impractical. It would be extremely difficult to estimate the percentage of completion of each home with any reasonable accuracy, because of the overall volume of ongoing construction and because many builders account for costs by tract and not by house.

Also, due to the high number of cancellations, builders almost certainly would have to amend their tax returns each year to reflect accurately the number of homes under contract at the end of the taxable year which actually close in the subsequent taxable year.

Mr. Chairman, in conclusion, let me note that sales contracts in housing developments are completely different than long-term construction contracts, mainly because the house typically is completed within a 12-month period of time. Also, the builder does not receive progress payments during construction. Thus, we think Congress never intended for these sales contracts to be treated as long-term contracts.

For this reason, I urge the committee to clarify that residential sales contracts are not intended to be treated as long-term contracts.

Mr. Chairman, thank you. This concludes my remarks.

Senator BAUCUS. Thank you, Mr. Stuard.

[The prepared statement of Mr. Stuard appears in the appendix.]

Senator BAUCUS. Mr. Graff.

STATEMENT OF GLENN GRAFF, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, LINBECK CONSTRUCTION COMPANY, TESTIFYING ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA; HOUSTON, TX

Mr. GRAFF. The construction industry has been hit hard by two major tax law changes in two years.

The changes to the method of accounting for long-term contracts in 1986 and 1987 brought widespread confusion to both the construction industry and the accounting practitioners.

The administrative difficulties that the construction industry is encountering as firms struggle to implement the new rules are far greater than the industry or the government estimated. Firms are finding that the amounts they are paying to have their tax returns prepared this year are at least double the previous year's.

For example, I know of one construction firm that paid nearly $100,000 for preparation of its 1987 federal return, double the cost of the prior year.

AGC urges Congress to make no changes to the method of accounting for long-term construction contracts this year; rather, AGC respectfully asks the Congress to address certain problems that construction firms are encountering in trying to carry out the new percentage-of-completion method.

These problems center around the implementation of the look-back rule. AGC believes that the interests of simplification and fairness could best be served by repeal of the look-back method.

It is important to note that the Joint Committee Tax staff has said repeatedly that the look-back method is revenue-neutral. However, the look-back rule will cost the construction industry millions of dollars annually. These additional costs stem from what, for most construction firms, will be thousands of additional calculations each year.

This look-back rule has proven to be an administrative and accounting nightmare. A construction contractor can spend literally thousands of dollars to discover whether it should receive $10 from the IRS.

For example, a construction contractor in Georgia had gross receipts for his 1987 taxable year of $10.3 million. He had 30 contracts open at the end of the taxable year. Each of those contracts was subject to the look-back provision. The largest contract was for $1.9 million; the smallest was for $600.

The contractor's accountants made the look-back computations and determined the contractor was due $1.35 in interest on the $600 contract. The contractor paid nearly $20,000 for the preparation of his tax return, approximately the same cost as his company's audit for the entire year.

Construction contracts unfortunately do not always finish in a neat and orderly fashion. Increments of both costs and revenues related to a contract may continue to dribble in on a sporadic basis for years. The look-back rule requires all of the calculations I previously noted to be done each and every year on each contract that has additional revenue or costs.

Mr. Chairman, this concludes my remarks. Thank you.

[The prepared statement of Mr. Graff appears in the appendix.]

Senator BAUCUS. Thank you very much.

Mr. O'Brien, one question that I have is about the degree to which the industry can encourage changes in terms of the contract, so that income, cash flow and receipts match, say, the cost of the contract in any given taxable year; that is, the degree to which the industry can go back to the government or its suppliers and work out a cash-flow and receipts income schedule which more approximates the cost incurred to the contractor, in the event that there are continued changes and cutbacks in the completed-contract method of accounting.

Mr. O'BRIEN. There is no way under existing contracts that we can go back through—

Senator BAUCUS. That is right. I am talking about as a practical matter with future contracts.

Mr. O'BRIEN. Because you are in effect under the proposed change, taxing us on income not received, there is no way that we can make up that shortfall.

We would have to try to finance that shortfall. And since it is not a legitimate revenue item, we cannot even finance that. So, we will be borrowing against our equities at all times. We cannot process changes through our subs to offset those shortfalls in financing.

Senator BAUCUS. I understand that. But I am talking about in the future, as you enter into and negotiate new contracts. As a practical matter, to what degree can those changes be made?

Mr. O'BRIEN. It is impractical to make any, in my opinion. We cannot raise the profits—we have a profit-limiting bill imposed on us by other members of the Senate and Congress. Where do we generate the added income? In my view, there is no way to generate added income to offset this problem, if I understand your question, sir.

Senator BAUCUS. Well, we don't have the time to go into it in more detail. But it does seem at least an area to explore, the practicality of those subsequent changes in future contracts. And the degree or not that that is possible has some bearing, I think, on the merits of the provision before us.

Mr. Stuard, you suggest a 12-month extension for home builders.

Mr. STUARD. Yes, sir.

Senator BAUCUS. Why shouldn't that also apply to other contracts or other businesses in addition to home builders?

Mr. STUARD. Well, I think the reason that we are suggesting the 12 months is because of the absolute dissimilarity between a sales contract and a construction contract. In other types of businesses where you do have a 12 month contract, you have a reasonable assurance, by the document that you have signed, that that contract is going to be fulfilled. In a sales contract there is no reasonable assurance of that; the buyer virtually has the right to withdraw from that contract at any time.

So therefore, the similarities don't exist, and the sales contract aspect should be completely withdrawn from the proposal.

Senator BAUCUS. All right.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BAUCUS. Senator Danforth?

Senator DANFORTH. Mr. O'Brien, there was an article in the business section of Sunday's New York Times about the defense industry. The point of the article was that the defense business isn't that great a business to be in anymore. It talked about changes in procurement, and the fact that this Pentagon thing that everybody has been reading about in the paper has got Congress' dander up. But it did not mention the repeated changes we have made in the tax laws.

Do you think we are in danger in Congress of doing serious damage to an essential industry in this country?

Mr. O'BRIEN. I believe that the tax laws changes which have impacted us most seriously, coupled with the other revenue impositions on us—the sharing in investments, the reductions of progress payments that do not relate to current interest rates—all combined, are dangerously liquidating the aerospace industry in this country, as the British did 30 years ago in their leading technology industries. And we in the industry are very concerned about that.

Let me make a point, Senator, if I may: We are not asking you to repeal any laws that have been passed to date. We have proposed to the Joint Committee revenue-taxing methods that would be much more fair and equitable, and that would have us, the industry, taxed at rates equal to the rest of industry.

So, we are not asking for any forgiveness or any repeals; we are merely asking that this added burden not be placed on us without further study because of the damage.

Senator DANFORTH. My understanding of your testimony is you are saying, "All right, Congress, you have now, three times to date, taxed the completed-contract method of accounting; you are going back for the fourth time in this decade. So, do away with it; but before you do away with it, at least make some changes in the percentage-of-completion method that make it more fair for our industry." Is that right?

Mr. O'BRIEN. That is exactly our position, Senator.

Senator DANFORTH. And, "Don't jump the gun on this, at least."

My understanding is, you begin paying taxes before you even get the contract.

Mr. O'BRIEN. Let me use an F-14 as an example, which is nominally a 5-year contract with the U.S. Navy to produce airplanes out in the future—3 to 5 years. We will pay taxes, under the present rules, the day we order the material, which will not be turned into an airplane for between 3 and 5 years, on an assumption that all of our costs generate equal profits, which is a false assumption and is nowhere imposed on any other industry.

Senator DANFORTH. And there is, generally, retainage—isn't there?—on the payments that you receive?

Mr. O'BRIEN. There are, generally.

Senator DANFORTH. So about 20 or 25 percent, typically, of the total amount that you receive in the contract is held back to the end of the contract?

Mr. O'BRIEN. That is correct, and liquidated as deliveries are made.

Senator DANFORTH. So, you are paying taxes when you are ordering the material to be made into a plane 3 to 5 years from now, and you are being paid at the back-end of the contract period?

Mr. O'BRIEN. Let me make it even more simple. If your tailor ordered a bolt of wool, he would pay taxes when he got the bolt of wool, even though you didn't order your Fall suit until November or get it until December.

Senator DANFORTH. In your testimony you have a table which indicates that, under current law, without this bill that the House is about to pass, the effective tax rate for the aerospace industry in the next 5 years would range from 37 percent to 68 percent. Is that correct?

Mr. O'BRIEN. Yes, sir.

Senator DANFORTH. And that with a full repeal it would range from 39 percent to 76 percent?

Mr. O'BRIEN. Yes, sir.

Senator **Danforth**. And what you are saying is, before we go up to a 76 percent effective tax rate on your industry, let us at least look at some of the problems for the percentage-of-completion method?

Mr. **O'Brien**. Yes, sir. I am effectively saying, "You have been unfair enough."

Senator **Danforth**. Thank you very much.

Senator **Baucus**. Senator Chafee?

Senator **Chafee**. Mr. O'Brien, I am interested in the international point of view and your comment about the demise of the British aerospace industry; although, judging from the latest contracts they got from the Saudis, I guess they are not totally "demised," if that is a proper word.

Tell me, you are here not speaking solely on behalf of Grumman but you are here speaking on behalf of the Aerospace Industries Association?

Mr. **O'Brien**. That is correct.

Senator **Chafee**. Grumman itself does not do much export, do they?

Mr. **O'Brien**. Yes, we do a fair amount.

Senator **Chafee**. Do you?

Mr. **O'Brien**. We have exported some of our airplanes, through the Navy and through the Air Force, to foreign countries.

Senator **Chafee**. But I am looking at your membership: McDonnell Douglas, Raytheon, General Dynamics, and Boeing. Could you just amplify briefly on what the effects of all of this would have on your exports? As an industry, you are a major exporter and yielder of dollars for the United States in the trade surplus.

Mr. **O'Brien**. The problem is deeper than the tax law, of course, Senator. The problem has to do with the competition with rising aerospace industries in Europe and Japan, heavily in competition with our leading fighter manufacturers, some of whom you have mentioned, including ourselves, and our commercial aircraft manufacturers.

The tax laws, the progress-payment laws, the tooling laws, all are reducing the revenues of the industry at a time when the subsidies to our competing industries in other countries are rising.

The Japan aircraft industries are part of the Japanese Government. The European industries are part of the European government. For Margaret Thatcher to say she is not lending money to Rolls Royce is to pull the wool over our eyes; she may not be lending money to them, but she is deferring payments and canceling payments in future years.

So, when Rolls Royce, for example, competes with Pratt & Whitney or General Electric, they are competing on a subsidized basis.

If we do not have the monies to keep the lead in technologies which have allowed us to control the worldwide markets to date, we will be surpassed and unable to compete.

The British industry went through that cycle and are now being dramatically subsidized by the government in all of their competitions. We know that for a fact.

If you wish to have a fully-subsidized defense or aerospace industry, we are well down the track in that direction by imposing on us laws that reduce our ability to earn and invest in the future.

That is the extrapolation of how we get there, Senator. It is not just the tax law.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator.

Senator Matsunaga?

Senator MATSUNAGA. Thank you, Mr. Chairman.

It has been said that there are two certainties in life: death and taxes. The major difference is that death doesn't get worse every time the Congress convenes.

But now, as applied to your respective industries, are the current tax laws better than what is being proposed?

Mr. O'BRIEN. I would have to exclude the 1982, 1986, and 1987 changes, but we are living with those. I think the damage has been done by those, only in the method.

We are willing to pay what the Senate decides is the reasonable rate of taxes. But the imposition of the laws as scheduled has raised our tax rates to higher than the other industries, nominally higher than the industries in this country. That is our concern. We believe we should pay our share, as an industry, of the tax burdens of the nation.

Senator MATSUNAGA. I haven't yet had the opportunity to read your written testimonies, but I do intend to do it. But, Mr. Stuard, will you state your position as related to your industry?

Mr. STUARD. Well, Senator, I think as I listen around the table here, you are right, death and taxes are always certain. But from the time I was a young man I always heard the word "income" taxes, and we seem to have gotten to the position in the last go-around here that we are now taxing people before income is derived, and that is what is being proposed now by this new IRS ruling. It would literally impose taxes upon us before we have bookable profits.

Senator MATSUNAGA. Well, I believe the present Administration does not refer to such increases as "income taxes" but "revenue enhancements." (Laughter)

Mr. O'BRIEN. I think that is exactly what we have gone through. I think that is a mistake for our country, to get into a position where we are not longer an "income" taxing country.

Senator MATSUNAGA. Mr. Graff?

Mr. GRAFF. Senator, our industry is opposed to any further changes in long-term contract accounting. However, one of our primary concerns is the administrative burden that has come upon us because of the 1986 and 1987 Acts.

We are asking for relief from that administrative burden. The primary burden is revenue-neutral, but it is costing us millions of dollars to comply. That is our major focus.

Senator MATSUNAGA. Thank you.

Mr. GRAFF. Thank you, sir.

Senator MATSUNAGA. I wish we had a little more time, but in the interests of time, Mr. Chairman, I have no more questions.

Senator BAUCUS. Thank you all very much. Thank you for your testimony. You have made some good points that have not been lost upon this committee. Thank you again for appearing before us today.

Our next panel is Mr. John Chapoton, who is the Managing Partner of Vinson and Elkins, testifying on behalf of Goldman, Sachs and Merrill Lynch; Mr. Anthony Graziano, Senior Vice President of Triangle Industries, on behalf of the U.S. Chamber of Commerce and the Dividends Received Deduction Coalition; and Mr. Nelson Stephenson, Senior Executive Vice President and Chief Financial Officer of East River Savings Bank, on behalf of the U.S. League of Savings Institutions and the National Council of Savings Institutions of America.

Let us begin with Mr. Chapoton.

STATEMENT OF JOHN E. CHAPOTON, MANAGING PARTNER, VINSON & ELKINS, TESTIFYING ON BEHALF OF GOLDMAN, SACHS & CO. AND MERRILL LYNCH & CO., WASHINGTON, DC

Mr. CHAPOTON. Thank you, Mr. Chairman.

I think I can be very brief. My point, addressing solely the dividends received deduction, is that a reduction of that corporate deduction is incompatible with sound tax policy. It violates a basic premise of sound tax policy—that is, neutrality.

I would also point out that most of the revenue is going to come from its retroactive effect; it is going to reduce the value of existing stock held by corporations. Some of that hoped-for revenue may not be produced because there will be tax losses, capital losses, generated by the reduction in value of existing corporate stock, and by changes in corporate finance for the future.

I think the thing for the committee to keep in mind, Mr. Chairman, is that any argument that the dividends received deduction is not necessary has got to rest on the premise from a tax policy standpoint that we really do not mind more than two taxes paid on equity-financed corporate income if it flows through more than one corporate entity. We really don't mind it being triple-taxed or more.

Another way to say this is that we really do not want corporations providing equity financing for other, unrelated corporations. If we remove the dividends received deduction we are indeed, for some reason, as a policy matter, discouraging one corporation from investing its funds in the equity of another corporation, because as we noted, if it does so, then it will be subject to more than two taxes. And obviously, corporations will react, and they will provide less equity to other corporations.

The main argument we hear for removing or reducing the dividends received deduction is that corporate dividends should be like any other corporate income. It sounds persuasive, but when you work through the math—and I think the math is quite simple; there is an example on page 7 of our written statement—the only way that you achieve neutrality between corporate investment opportunities is to provide the dividends received deduction. Otherwise, you are imposing three taxes on the stream of income that was represented by the dividend income.

That is my point, the one that you have to decide. If you don't mind triple taxes, you don't mind reducing the dividends received deduction. But if you do, you cannot reduce the dividends received deduction.

[The prepared statement of Mr. Chapoton appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Chapoton.

Mr. Stephenson?

STATEMENT OF NELSON L. STEPHENSON, SENIOR EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, EAST RIVER SAVINGS BANK, TESTIFYING ON BEHALF OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS AND THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS, NEW ROCHELLE, NY

Mr. STEPHENSON. Good morning.

I would like to limit my remarks to the specifics of the issue related to the Dividends Received Deduction, simply because we think, from the institutional perspective of the savings institution, that our industry will be accessing the capital markets in a substantial way over the next three to five years.

We would like to make the point that has been made previously, that the elimination of the triple taxation provisions that have been described is very, very important to corporate finance.

We would also like to make the point that we believe there has been an insufficient amount of research done with respect to a change of this magnitude. We are just slightly under nine months beyond a period of extreme stress in the financial markets, and it is our belief that a change of this nature will produce an unknown effect on the capital markets.

We are very, very much concerned about the limited access and the increased cost of accessing capital, and we believe that the changes that are being proposed are simply something that is not mandated by the amount of revenue that is being raised.

We believe also that fairness would demand a prospective application of this provision. We clearly feel that current stockholders and people who have purchased shares have done so in reliance upon the Tax Code that has existed since 1917.

We also believe that issuers have made significant corporate finance decisions on the basis of the particular economics of the case caused by the current tax structure.

So, in conclusion, we would like to preserve the 70-percent Dividends Received Deduction. But if this has to be enacted for some reason, we would propose that it not be retroactive but would be prospective in application.

Thank you.

[The prepared statement of Mr. Stephenson appears in the appendix.]

Senator BAUCUS. Thank you very much, Mr. Stephenson.

Mr. Graziano.

STATEMENT OF ANTHONY W. GRAZIANO, SENIOR VICE PRESIDENT, TRIANGLE INDUSTRIES, INCORPORATED, TESTIFYING ON BEHALF OF THE U.S. CHAMBER OF COMMERCE AND THE DIVIDENDS RECEIVED DEDUCTION COALITION, NEW YORK, NY

Mr. **Graziano**. Thank you, Mr. Chairman.

I am a Senior Vice President of Triangle Industries, and today, gentlemen, I am appearing on behalf of my own company, The Alliance for Capital Access, the U.S. Chamber, and the Dividends Received Deduction Coalition.

The point we would like to make to you is that the DRD is not simply an arcane tax issue; it fundamentally affects the economics of capital formation.

Contrary to popular perception, corporations are significant purchasers of the stock of other corporations. In fact, in the $43 billion public preferred stock market alone, nearly 80 percent of the purchasers are companies eligible for the DRD.

Since 1986, the DRD has been reduced from 85 to 70 percent, and now we are talking about further reductions. The effect is going to be to increase substantially the cost of raising capital for industrial, utility, and financial corporations.

Triangle itself is an example of a company that has benefited significantly from the DRD. Through our flagship, American National Can, we are the largest packaging company in the world. We are also the lowest cost producer in most of the markets in which we compete, both domestically and internationally.

We employ about 23,000 American workers, and we are only one of 57 companies in the Fortune 100 who have had net positive employment growth in the last 10 years.

There is no question, we think the DRD has assisted us in this record of growth.

The practical reasons for the DRD we think are compelling. Simply put, industrial companies need capital to grow. To attract this capital, we must offer investors a competitive after-tax return.

If the DRD is reduced, investor tax liability rises, and we must offer higher yields to business investors to continue to attract their money. A higher cost of capital makes it more difficult for us to grow, to create jobs, and to compete in global market.

We would urge you, gentlemen, when you look at revenue enhancers, as I know you must, that you pay attention to the effects on the industrial companies of what you must do. Let us earn money, but give us the ability to raise capital so that we can continue to compete.

Thank you.

[The prepared statement of Mr. Graziano appears in the appendix.]

Senator **Baucus**. Thank you, gentlemen.

It is obvious that there is, at the very least, a theoretical and probably practical effect of continued changes in the Dividends Received Deduction for a corporation to move away from equity into debt financing.

I am wondering if any of the three of you are aware of any specific studies or could give some direct evidence of what actually in fact did happen in 1986 and 1987, when there were earlier changes.

That is, to what degree did utilities move into debt financing, or savings and loans change their preferred stock position?

I am trying to determine not the theory but the facts. That is, what evidence is there, and what specific evidence can you refer to to show the degree to which the adverse consequences that you mentioned in fact occurred?

Mr. CHAPOTON. Well, Mr. Chairman, I think we can, and we would be happy to provide information to the committee to show the change in price of preferred stock as a result not only of the 1987 changes but of the Ways and Means proposal this year—that would be the most dramatic impact.

I think what we are talking about is the effect on the cost of capital. That is where the impact would be.

Senator BAUCUS. Are either of the other of you aware of any data that this committee can look at?

Mr. STEPHENSON. No, Mr. Chairman, I am not. I can just give you practical, inside-a-company kinds of experience.

When we go out to try to market preferred stock today, investors want a higher yield. They want a higher yield because they figure their after-tax return is going to be diminished as a result of what you are doing, or perhaps doing.

I might also suggest to you that the investing community is somewhat cynical since there have been two reductions recently in the DRD and this would be the third in three years. People are believing that the DRD is a dead letter, and that the next step a year from now is going to be to take away the rest of it.

So, we are already seeing, when we discuss rate with our investment bankers, that people are assuming that it is going to get worse in the future.

So we are presented with higher rate quotes from our investment bankers. That makes us tend to want to finance more with debt rather than with equity. And while I certainly think that there is an appropriate use of debt in the balance sheet—and my company has a fair amount of it—too much of a good thing is not good, either, Senator.

Senator BAUCUS. Mr. Stephenson?

Mr. STEPHENSON. I would simply comment that the effect of these provisions on the capital markets can be somewhat chilling. You can have tremendous uncertainty with respect to the application of provisions like this, which can effectively dry up access to capital almost immediately.

The one thing that capital markets can't deal with very well is uncertainty, and investors do demand a direct and immediate increase in cost for taking the risk that the provisions will change.

I think that is one of the reasons we think a retroactive application of something like this imbalances the market, from the perspective of an investor's concern over his retention of what was previously negotiated, and in an issuer's perspective, changing the rules in which he has established his entire corporate structure from a financial perspective.

Senator BAUCUS. Thank you.

Very briefly, what about this prospective/retroactive question? I mean, of old stock and new stock. It just seems to me that, if Congress moves in the direction of the Ways and Means proposal and then makes it only prospective, and you have different categories of stock, it is a further complication, and I don't know how wise it is.

Very briefly, I would like your reactions to that.

Mr. Chapoton?

Mr. CHAPOTON. Well, I think if you make the change prospective, you would find it loses almost all the revenue. But doing this would simply take away the objection that it has a retroactive effect. It would still have exactly the same effect on future corporate decisions—moving more toward debt, less toward equity.

Mr. STEPHENSON. Senator, I have the same reaction. As a company that would like to build more plants, when we go out to raise the money we are going to be a new issuer, and we are going to face the problem of higher rates on preferred. So we are going to lean more toward debt financing than equity financing. And I am not sure that increasing the leverage of American corporations is a very wise thing.

Senator BAUCUS. Well, frankly, I think all of you make a very good and even deeper underlying point. In some degree, here we are today, thinking very short term. That is, we are trying to face a one-year budget cycle, and a technicals bill, and try to find out in a very short period of time how to raise some revenue, rather than looking long term.

I strongly encourage your industry and others this year to begin addressing how we raise revenue next year, because I think the future of this country very much depends upon not only whether it raises revenue—and I think to some degree it must, in addition to cutting expenses to get the budget deficit down—but even more importantly, how we raise revenue.

I tend to think we are going to have to move further away from savings and investment as a source of raising revenue and more on the consumption side, whether it is excise taxes or whatever. But I think it is worth our time this year to think of how we begin to address these questions next year.

America is thinking more long term: how it is raising revenue in a way that increases productivity and lowers the cost of capital—the comparative cost of capital as compared to other countries and because our cost of capital, as we well know, is still significantly, on a comparative basis, higher than it is in other countries. And we are kind of nickel and diming here in the wrong way, instead of thinking more long term.

I have no further questions.

Senator Chafee?

Senator CHAFEE. Just one quick question of Mr. Chapoton.

Mr. Chapoton, in your prior incarnation, or maybe it was with Mr. Mentz, your successor, we went through this business of increasing the amount that was non-deductible.

I must say—and I am not trying to pin you down on what took place in those years—I have never understood it. To me it seems that we are subjecting any income to, as you say, a triple tax—it is being taxed three times. I never quite understood the philosophy of it.

But when we changed it, I guess it was in connection with the 1986 bill.

Mr. CHAPOTON. That is correct.

Senator CHAFEE. We received remarkably little objections. I mean, we were besieged, as members of this committee well remember, on everything we did; but on that particular issue, I was just surprised how little resistance there was from the business community.

Can you account for that in any way?

Mr. CHAPOTON. Well, I think, Senator, as you will remember, there were several other things going on—

Senator CHAFEE. That were far worse?

Mr. CHAPOTON. Well, in 1986, if you are talking about the tax rates, for the better. The whole theory in the 1986 change in the dividends received deduction was that without a reduction in the percentage of the deduction, you would have a significant reduction in tax on portfolio income as compared to pre-1986 law. It was not a philosophical change; it was simply saying we want the tax on portfolio dividend income to stay at about what it was before.

But when you get into the philosophical side of it. you had the 100 percent dividends received deduction for all corporations from 1909 to 1935. In 1936 it went to 85 percent and essentially stayed 85 percent until 1986. And then the 1986 change was just an aspect of corporate rate reduction.

I am not really surprised there wasn't much reaction to it. The philosophical side was not the focus in 1986.

Senator CHAFEE. Oh, I think at some point we ought to look at the philosophic side and determine what we are doing here, as you mentioned in your testimony.

Thank you very much, Mr. Chairman.

Senator BAUCUS. Thank you.

Thank you very much, gentlemen, we appreciate your testimony.

The final panel is Mr. Richard Hauslein; Mr. Barry Zigas, and Mr. Malcolm Moore.

Senator PACKWOOD. Mr. Hauslein, go right ahead.

STATEMENT OF RICHARD E. HAUSLEIN, VICE PRESIDENT, HUMAN RESOURCES, DRESSER INDUSTRIES, TESTIFYING ON BEHALF OF THE ERISA INDUSTRY COMMITTEE AND THE SECTION 89 COALITION, DALLAS, TX

Mr. HAUSLEIN. My name is Richard Hauslein. I am Vice President for Human Resources, Dresser Industry, of Dallas, Texas. I am appearing before you today at the request of the Section 89 Coalition, and The ERISA Industry Committee.

My testimony will outline, from a Dresser perspective, important issues concerning Section 89, Non-Discrimination Rules included in the Tax Reform Act of 1986.

Let me make it clear that we endorse the concept of non-discrimination rules for welfare plans. Unfortunately, Section 89 as it currently stands does more to test the ability of the employer to gather data than to ensure an equitable distribution of benefits, and it positively discourages the expansion of health coverage.

It is not likely that Dresser or any other major company will drop their health coverages because of these rules. Most major companies think they run non-discriminatory plans and will make every effort to pass whatever rules are laid out. The issue is just the high cost of compliance.

In many cases, employers with good health plans simply will not be able to tell whether their plans pass these rules.

The Ways and Means Committee proposals address some of the symptoms but fail to go to the heart of the problem. We need more substantive relief, including safe harbors to make it possible for health plans to pass non-discrimination rules without resorting to elaborate, costly, and burdensome testing.

Time is very short. Section 89 rules are effective beginning January 1, 1989. Failure of the committee to find a way to implement welfare benefit non-discrimination rules on a phased-in and gradual basis will cause chaos in an area vital to the health and wellbeing of employees and their families.

Mr. Chairman, we need your help, and we ask for your help.

[The prepared statement of Mr. Hauslein appears in the appendix.]

Senator Packwood. Thank you. Mr. Zigas?

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION, WASHINGTON, DC

Mr. Zigas. Mr. Chairman, thank you for inviting me here to testify on the Technical Corrections Act.

My name is Barry Zigas. I am President of the National Low Income Housing Coalition, which is a national nonpartisan nonprofit group representing advocates and consumers for low income housing.

Given the shortness of the time, I would like to submit my written statement for the record and simply focus on one part of the testimony that I prepared for the committee.

We believe that, in the issues confronting this committee on the Technical Corrections, the very most important for low income housing is the extension of the Low Income Housing Tax Credit beyond its current expiration at the end of 1989, and we fully support the efforts of Senators Mitchell and Danforth and the other 48 cosponsors of S. 2411 to extend the tax credit to 1990. I note that 11 members of this committee are cosponsors of the legislation and very much appreciate the support you have shown for it.

I would like to respond very briefly to Secretary Chapoton's comments about the extension.

Housing development, particularly for low income people, is an extremely time-consuming and risky process. Companies, non profits and for-profits, who cannot be assured they will have credits available for their investors when their property is completed will not undertake the extensive expense of acquiring land, undertaking architectural engineering expense, and the other parts that housing development require.

We are hearing from our nonprofit members, who are actively using this credit throughout the country to produce housing that is affordable to poor people, that if they cannot be assured credits will be available in 1990, that they are not going to start projects any much further along than this Fall, because the process is too uncertain, takes too long, and requires too much investment, and you cannot get commitments for equity without the assurance of the credits.

I would like to add to my written statement an additional series of comments on S. 2411, which I would just like to submit for the record.

I finally note that the National Low Income Housing Coalition's Board had a long debate about whether to support extension of Mortgage Revenue Bonds, and we decided that we would, because so many of our people are working in communities where home ownership for moderate income people is also an impossibility.

I would note one of the recommendations that our members made was that this committee try to find a way to ensure that, when State agencies provide these proceeds of the bonds to lenders, that the lenders are required to undertake affirmative marketing to low income households, and that institutions that are in those communities and relate well to those borrowers are used and if necessary given preference to ensure that the lowest possible qualifying income households get the advantage of the Mortgage Revenue Bonds. And with those stipulations, we would support extension of the Mortgage Revenue Bonds.

Thank you for your comments, for the opportunity to testify, and I will be happy to respond to any questions.

[The prepared statement of Mr. Zigas plus his additional comments on S. 2411 appear in the appendix.]

Senator Packwood. Thank you.

Mr. Moore?

STATEMENT OF MALCOLM A. MOORE, PRESIDENT, THE AMERICAN COLLEGE OF PROBATE COUNSEL, SEATTLE, WA

Mr. Moore. My name is Malcolm Moore, and I am President of The American College of Probate Counsel, which is a national organization of probate and trust attorneys consisting of some 2600 members.

I am here to testify on Section 2036(c), the so-called "Estate Tax Freeze Provision" passed last December. If there was ever a Code section in need of technical and substantive help, it is this one.

Our organization and a number of other professional organizations around the country have spent a lot of time looking at this statute. The effect of the statute, without improvement, is that virtually every intra-family transaction involving a transfer of property from an older generation to a younger generation has been put on hold. I do not exaggerate. It has virtually paralyzed what used to be the every-day transfer of property from one generation to another.

The statute was designed to deal with abusive anti-freeze situations wherein adequate transfer tax was being paid. It is so broadly drawn that it affects virtually every intra-family transaction.

Unfortunately, the Ways and Means Committee's suggestions with respect to Technical Corrections did not make it better; they made it worse. They don't define admittedly ambiguous terms; they provide so-called "safe harbors" which are so narrowly construed as to be illusory in terms of the protection they offer. You violate one requirement in an area, and you are out of the safe harbor.

And finally, they not only don't correct the inadequacies, they go further. The Technical Corrections proposed by the House would even include situations that the statute would cover that are not now covered.

As I said, the result of the existence of the legislation as is, without substantial technical correction and different technical correction than the House has produced, has been to really discriminate in favor of family businesses, closely-held businesses, where in effect a family's stock is worth less to a family member than it is to an outsider because estate tax will have to be paid in the end by the family member buying that stock—not even receiving it by gift but buying it—from an older family member. It is better for the older family member and the family to sell it to an outsider than to sell it to a child. And that can't be something that Congress would have in mind in passing Section 2036(c) or even the Technicals.

Both the Minority and Majority Staffs of this Committee, I believe, are looking at a different approach to dealing with truly abusive freeze situations. We support them in that effort and will be of help to them should they desire.

[The prepared statement of Mr. Moore appears in the appendix.]

Senator PACKWOOD. Thank you, sir.

Mr. Zigas, let me ask you what happens if we extend this credit for a year, and then we get to next year. Because, as I understand, part of the argument is: Things that are online now simply won't be completed. Do you mean that nothing will be started next year, even with the extension of the credit, because you wouldn't be able to finish it in the ensuing year with the credit expiring?

Mr. ZIGAS. Well, Senator, I think it is an excellent question. Clearly, as you sunset these kinds of provisions that offer incentives for equity investment in development and preservation of low income housing, you are constantly going to face this problem.

We have only sought a one-year extension with the belief that next year Congress is likely to revisit many substantive areas in the credit. If we do not resolve them, surely we will be back next year making the same argument, because it will apply. But I think it is our expectation that this is kind of a transition year for the committee and for the Code, and that substantive changes will not be made, and that in light of that it is necessary to just keep us moving, because so much expertise is being developed in this.

I might also add that one of the difficulties we have confronted is, it is now getting into the later stages of 1988. The credit was adopted in late 1986. We still don't have a full set of regulations governing the use of the program, which is then another hurdle that we have not been able to overcome.

So there are a lot of issues about utilization and the credit that allowing the sunset to stay in place would simply be kind of the final nail in the coffin. It says to people doing this work that "it is unlikely to be extended, we shouldn't be investing time and energy in it, so let us go do something else," and that is exactly the situation we want to avoid.

Senator PACKWOOD. Actually, based on our experience, we should have known I guess when we passed the Tax Reform Bill that the regulations would not be out in time for Mr. Moore, for you, or for any number of other people, the Non-Discrimination Rules, that they just wouldn't. They haven't been in the past. I am not sure it is anybody's fault.

Mr. ZIGAS. No, and I don't mean to suggest it is. It is just one of a series of hindrances, and it is one of the reasons I really can't agree with Secretary Chapoton's comments. I don't think it is possible to draw these kinds of inferences. The credit is being widely used in a number of localities; it has attracted large amounts of corporate investment through the use of the credit as equity in low-income housing. It is about the only device by which housing investment in preservation is taking place today.

Senator PACKWOOD. My hunch is we will revisit it next year. Whether we change it or not, I don't know, but there were three areas in the Tax Reform Bill where we weren't sure, and we knew we weren't sure, as to how it would work out. One was low income housing, and one was capital gains, and one was historic preservation.

But it wasn't a question were we flying blind; we thought it was worth the chance and that we would see over the ensuing years how it happened.

Mr. ZIGAS. Well, we appreciate your leadership on that issue in 1986, Senator.

Senator PACKWOOD. Mr. Hauslein, when was the Section 89 Coalition formed?

Mr. HAUSLEIN. It was formed in 1987, early 1987.

Senator PACKWOOD. I am curious—how was it formed?

Mr. HAUSLEIN. A group of employers who belonged to the ERISA Industry Council, formed together with other members from other areas of common interest, and created a study, worked with the Treasury Department in trying to develop the measures and values of how to value plans, and this sort of thing.

Senator PACKWOOD. Thank you.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Zigas, it seems to me that we have got two problems here, do we not? One is the extension of the Low Income Housing Tax Credit; and, secondly, some changes in it.

Now, I don't think you got into any depth in the changes, did you?

Mr. ZIGAS. Well, I did, in my written statement.

Senator CHAFEE. Yes, in your written statement, but in your oral statement did you?

Mr. ZIGAS. No, I did not.

Senator CHAFEE. I have looked over your statement just briefly here, and you cite some significant figures.

You touched on the Mortgage Revenue Bonds, also. Now, what exactly were you saying there? First, I was rather surprised that your group, the Coalition, hesitated over whether to even recommend the extension of the Mortgage Revenue Bond situation. But you did—not like a get-well card, "By a vote of 7 to 3, the committee wishes you a speedy recovery," but not very enthusiastically, I take it.

Mr. ZIGAS. I wouldn't characterize it that way. I think we had a lengthy and substantive discussion about the degree to which our coalition, which spends its time and energy trying to ensure the Federal Government's attention to the problems of low, very low income people—what our position should be on a program that is not generally perceived by our members as benefiting very low and low income people.

Senator CHAFEE. Because your members would be primarily renters?

Mr. ZIGAS. Well, our members are renters or homeowners who own their homes through programs or through loans that aren't covered by this program. And there is a sense among some of our members that people that are of very low income have not had good access to the program.

I believe, though, Senator that in having this discussion we came to an agreement that this is part of a series of tools that is necessary to provide different opportunities to different people along the home ownership spectrum.

Senator CHAFEE. Also, isn't it true that the more housing there is, the better it helps everybody, including those who are renters or low income people? That is not completely true; there are a whole series of exceptions.

Mr. ZIGAS. Well, I guess I would take exception. I would say I think it is the wrong way to characterize the housing economy. There are plenty of markets with a surplus of housing today where very poor people still cannot find affordable housing.

Senator CHAFEE. All right.

Certainly the folks I have been talking to, the housing directors from the various States, put the Mortgage Revenue Bonds right at the top of the heap as far as their concerns are, and these individuals are concerned with the low income as well as the medium income.

In our State the statistics are extraordinary. In one year, 70 percent of the mortgages taken out in our State were through the Mortgage Revenue Bond financing. I don't think there is a State in the country that comes even close to matching that.

And we have limitations. And that is what you were talking about.

Mr. ZIGAS. Yes.

Senator CHAFEE. As I understood, your final comments were that you wanted some limits on the income.

Mr. ZIGAS. Well, I think the limits on the income are established by the Congress, and I think the House bill makes some changes to those.

Of more concern to some of our members who have worked directly with the Mortgage Revenue Bond Program on behalf of their constituents was the question that they believe that, while policies may be enacted to provide first preference to lower income people, that there is not enough requirement or effort made in some States to require the lenders to have real affirmative outreach into low income markets. So, if preference is provided, the time slips by, no marketing is done, and people who come up at the higher ranges of the income limit get the mortgages instead.

Senator CHAFEE. You don't have to give it now, but I would be interested in which States you give high marks to in this, and just see what they do vis-a-vis the others. Do you have that?

Mr. ZIGAS. I would be happy to put together some information on the programs we think are exemplary.

Senator CHAFEE. Good. If you could send that to me, I would appreciate it.

Mr. ZIGAS. I would be happy to.

[The information appears in the appendix.]

Senator CHAFEE. Thank you, Mr. Chairman.

Senator PACKWOOD. Gentlemen, thank you very much.

The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was concluded.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

STATEMENT OF
JOHN E. CHAPOTON
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 13, 1988

My name is John E. Chapoton. I am a partner in the Washington office of the law firm of Vinson & Elkins. I appear today representing Goldman, Sachs & Co. and Merrill Lynch & Co. I am accompanied by J. Gregory Ballentine, a principal in the Washington office of Peat, Marwick, Main & Co. and a former Deputy Assistant Secretary (Tax Analysis) at the U.S. Treasury Department.

The sole subject I wish to address concerns the dividends received deduction ("DRD") allowed domestic corporations. To avoid multiple taxation of corporate earnings, the Internal Revenue Code permits corporations to deduct a specified percentage of dividends they receive from other domestic corporations. Under current law, a recipient corporation that owns so-called "portfolio" stock (stock representing less than 20% of the stock of another corporation by vote and value) may deduct 70% of the dividends received on such stock.1/

The Ways and Means Committee of the House of Representatives tentatively has determined to reduce the 70% dividends received deduction for portfolio stock to 50%, after a two-year phasedown. For the reasons set out below, this change to our current corporate tax system would be most unwise.

My remarks today focus on the basic tax policy rationale for allowing corporations a dividends received deduction. The DRD plays an essential role

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1/ The DRD is 80% if 20% or more and less than 80% of the outstanding stock is owned, and 100% if 80% or more of the outstanding stock is owned.

in our corporate tax system. The change proposed by the Ways and Means Committee has no policy basis; it is simply an attempt to raise additional revenue. The anticipated revenue may be offset, however, by market adjustments -- the capital losses on existing stock and the shift to a greater reliance on debt finance.

The Ways and Means proposal is an arbitrary and retroactive tax increase affecting large numbers of corporate taxpayers and increasing the current tax bias in favor of debt finance. Moreover, a further reduction in the DRD will affect adversely the issuance of preferred stock, which is a major source of low-cost funding for important sectors of the economy such as thrift institutions, banks, and utilities. For banks and thrifts this is of particular importance today, since preferred stock provides an important layer of equity protecting debt holders and depositors.

Taxation of Corporation Income

Under the Internal Revenue Code, we treat corporations as separate taxable entities. Income is first taxed when earned by a corporation, and is taxed again when that after-tax income is distributed to the corporation's shareholders in the form of dividends. This system gives rise to what is usually referred to as the double tax on corporate income.

The double tax applies only to income earned on equity capital. Corporate earnings attributable to debt-financed capital are taxed only once. The deduction for interest paid offsets the income used to pay the interest, so there is no tax at the corporate level; thus the only tax is that imposed on the debtholders' receipt of interest income.

Tax policy experts generally agree that the double tax on equity-financed corporate income is both inequitable -- it forces some taxpayers to pay two levels of tax while other, similar taxpayers pay only one tax -- and non-neutral -- it distorts financial decisions. The distortion of financial decisions causes corporations to be overleveraged -- to issue debt rather than equity -- thus increasing their vulnerability to insolvency and bankruptcy. This double tax, however, is firmly ingrained in our system for taxing corporations.

Key Role of the DRD in the Corporate Tax System

It is not my purpose today to debate the wisdom of the double tax on corporations. However, to understand the role the DRD plays in our corporate tax system, it is crucial to understand that the DRD is needed to prevent corporate income earned on equity capital that is invested in stock of a second corporation from being subject to greater than double taxation.

This is the basic point I am here today to discuss -- the potential for a "triple tax" if a dividends received deduction is not allowed. As the following shows, the DRD prevents arbitrary triple taxation and allows the tax system to treat different corporate investments in a neutral fashion.

The Triple Tax Problem

The need for a mechanism such as the dividends received deduction to avoid excessive taxation of corporate income is hardly a new concern. The DRD has been part of our tax law since the first federal corporate income tax was adopted in 1909. Although the percentage of dividends deductible has fluctuated over the years from 100% to the current 70%, the conceptual rationale for dropping the percentage below one hundred percent has never been articulated clearly. Indeed, the necessity for a full or almost full DRD as an integral part of our corporate income tax rarely has been questioned -- until recently.

Ignoring this history, the suggestion has been made recently that, where a corporation owns an "insubstantial" interest in the stock of another corporation, the dividends it receives on this investment should not be distinguished from interest income or other types of income this same corporate taxpayer might receive from an unrelated corporation.[2/] This view clearly rests on the belief that, as a policy matter, we should not mind if we impose greater than a double tax on earnings of corporations financed by corporate equity. I strongly disagree. As a policy matter, we should seek to avoid multiple taxation of the same income; two taxes are certainly enough.

This is no idle academic issue; multiple taxation of the same income raises the cost of capital to all corporations, including troubled thrifts and other financial institutions that now are experiencing the most difficulty in raising new capital. In addition, multiple taxation further discourages the use of equity financing by otherwise healthy corporations, thus fostering the deterioration of corporate balance sheets by increasing debt-to-equity ratios.

2/ Joint Committee on Taxation, Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means 164 (1987).

Examples of Triple Taxation

It is important to understand why the absence of a dividends received deduction creates a triple tax. Some simple examples will help.

> Direct Equity Investment. If an individual invests in a corporation by purchasing stock, that individual will be taxed twice on the resulting income. Suppose, for example, that an individual purchases $300 in stock in a corporation that invests the funds in a project earning a 10% rate of return. The $30 in earnings will be subject to the 34% corporate tax. When dividends are paid, the earnings will be taxed again to the individual investor at a rate of 28%.[3/] Thus, after $10.20 in corporate tax (34% of $30), $19.80 is left to pay out as dividends. The individual owes a tax of $5.54 on the dividends (28% of $19.80), leaving $14.26 as his after-tax return. Total taxes paid on the $30 are $15.74.
>
> Debt Investment. If the individual makes the same $300 investment by lending it to the corporation, the $30 of earnings is taxed only once, at the individual rate. The interest deduction allowed the corporation prevents any corporate-level tax. The total tax collected is $8.40; the after-tax return to the individual investor is $21.60 (versus $14.26 in the direct equity investment case).
>
> Equity Investment Through Tiered Corporations. If the individual invests the $300 by purchasing stock in a corporation (Y) which in turn purchases $300 of stock in another corporation (Z), triple taxation will occur if a full DRD is not allowed. Assuming Corporation Z undertakes the same project as in the earlier example, the results will be as follows:

	No DRD	Full DRD
Before-Tax Earnings to Z	$30.00	$30.00
Tax to Z (34%)	10.20	10.20
Dividend to Y	19.80	19.80
Tax to Y (34%)	6.73	-0-
Dividend to Individual	13.07	19.80
Tax to Individual (28%)	3.66	5.54
After-tax Return	9.41	14.26
Total Taxes Paid	20.59	15.74

As this example shows, a DRD is needed to maintain double taxation and prevent triple taxation. With no DRD, tax is collected three times and the total tax is $20.59, versus the total double tax of $15.74 when a full DRD is allowed. The case with a full DRD results in exactly the same total tax as when the individual invests directly in Corporation Z. There is no avoidance of full double taxation.

The extra layer of taxation that occurs in this third example is quite arbitrary. Some projects must bear it and others will not, depending on their

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[3/] The individual tax liability may be postponed, but not reduced, if the corporation retains the earnings instead of paying dividends immediately. Even if this occurs, however, the individual bears a tax burden equal to the full double taxation of dividends. The postponement of the tax through retaining earnings does not lower the present value of the tax burden below the burden resulting from the immediate payment of dividends.

ownership structure. Indeed, some projects may bear more than triple taxation, if they are financed through more than two tiers of unrelated corporations.

Neutrality Among Multiple Corporate Investments

The dividends received deduction prevents arbitrary triple taxation and allows the tax system to treat different corporate investments neutrally. For example, suppose that an individual invests $300 in Corporation Y through the purchase of stock. Corporation Y invests $200 of that in a project yielding 10%, but finds, for business reasons, that it is wise to delay a further $100 investment in that project. Corporation Y might invest this $100 in equity of Corporation Z, which in turn invests in a project yielding 10%. If a DRD is allowed, the full $30 of income on the $300 will be double taxed. If no DRD is allowed, two-thirds of the investment is double taxed and one third (the income on Z's $100 project) is triple taxed.

To continue the example, suppose Corporation Y later finds that it has become feasible to make an additional $100 investment in its project. Suppose that, to do so, Corporation Y sells its stock in Corporation Z to an individual for $100. If a DRD is allowed, then this transaction has no tax effect -- Z's investment would be double taxed if its stock is held by Corporation Y or an individual. If no DRD is allowed, however, then this entirely non-tax motivated transaction (Y's sale of stock in Z to an individual) would have important tax consequences on Z's pre-existing investment -- the triple taxation of Z's investment would be changed to double taxation once Z's stockholder becomes an individual.

Clearly, by maintaining uniform double taxation, the DRD treats underlying investment income in a neutral way, no matter how many tiers of corporate ownership may be involved. Some have argued, however, that a DRD actually causes a distortion by taxing a corporation differently depending on its sources of income. This argument, which is addressed in the example below, has a basic flaw; it fails to distinguish between the receipt of untaxed income and the receipt of previously taxed income.

> Example: Multiple Investments. This final example illustrates how the DRD maintains neutrality among multiple corporate investments. Suppose Corporation Y invests the $300 in equity raised from an individual investor as follows:

- $100 in a project that earns a 10% return.
- $100 in the debt (yielding a 10% interest rate) of Corporation W, which $100 Corporation W invests in a project earning 10%.
- $100 in the equity of Corporation Z, which Corporation Z invests in a project earning 10%.

The tax results would be as follows:

Use in Corp. Y's Business	Full DRD	No DRD
Investment	$100.00	$100.00
Income to Y	10.00	10.00
Tax to Y (34%)	3.40	3.40
Income to Y S/H	6.60	6.60
Tax to Y S/H (28%)	1.85	1.85
After-tax return to S/H	4.75	4.75
Purchase Debt of Corp. W		
Investment	$100.00	$100.00
Income to W	10.00	10.00
Tax to W	-0-	-0-
Income to Y	10.00	10.00
Tax to Y (34%)	3.40	3.40
Income to Y S/H	6.60	6.60
Tax to Y S/H (28%)	1.85	1.85
After-tax return to S/H	4.75	4.75
Purchase Equity of Corp. Z		
Investment	$100.00	$100.00
Income to Z	10.00	10.00
Tax to Z (34%)	3.40	3.40
Income to Y	6.60	6.60
Tax to Y (34%)	-0-	2.24
Income to Y S/H	6.60	4.36
Tax to Y S/H (28%)	1.85	1.22
After-tax return to S/H	4.75	3.14

In this example, a neutral tax system would impose the same tax on the three different $100 projects undertaken (one each by Corporations Y, W and Z), all of which earn 10%. If a dividends received deduction is allowed, that is what occurs. The project Y invests $100 in directly is double taxed. The project W invests in is not taxed to W, since its $10 of gross income is offset by $10 of interest expense. Instead, Y is taxed on this $10 as it receives $10 of interest income. This amount will, in turn, be taxed again to the equity investor in Y. Thus the income on W's $100 investment is double taxed. Corporation Z's $100 investment also will be double taxed. This neutrality occurs in spite of the fact that, due to the DRD, Y pays no tax on its dividends from Z.

If no DRD were allowed, it might appear that neutrality would be achieved -- Corporation Y would pay full tax on its $10 of income from its project, on its $10 of interest income, and on its $6.60 of dividend income -- but, in fact, Z's project would have been overtaxed arbitrarily. The key difference between the dividends received by Y, on the one hand, and its interest income and income from its own project, on the other, is that the dividends represent previously-taxed corporate income.

The Debt Versus Equity Dilemma

The preceding examples also illustrate a basic tension that exists in our corporate tax system, one that has many unfortunate consequences: income from an equity investment in a corporation is subject at least to a double tax, while income from a debt-financed investment in a corporation is single taxed. This bias toward debt often causes corporations to raise capital through debt issues, when the issuance of common or preferred stock would be more prudent.

Reducing the dividends received deduction does not diminish the tax bias in favor of debt over equity; to the contrary, it exacerbates this problem. As the examples demonstrate, equity financing becomes more expensive from a tax standpoint -- and debt financing is relatively more tax-favored -- as the double tax on corporate earnings from equity investment is increased, to a triple tax or even greater, due to reduction in the DRD. Clearly, reducing the DRD moves in the wrong direction by exacerbating the tax bias in favor of debt.

Loss Corporations

Loss corporations face a different set of considerations when raising new capital. A corporation that has no current taxable income and thus cannot utilize currently the deduction for interest paid on debt receives no tax benefit from raising debt capital. Not surprisingly, such loss corporations do not find debt financing as attractive from a tax standpoint as do taxable corporations. There is no abuse or manipulation involved; it is just an unavoidable economic consequence of allowing a deduction for interest paid on debt capital.

Loss corporations therefore tend to issue common or preferred stock for new funds more often than corporations that are fully taxable and can utilize the interest deduction. However, a loss corporation issuing stock receives no unusual benefit from the DRD available to a corporate purchaser of its stock. If the DRD were reduced or removed for dividends on stock issued by a loss corporation primarily to other corporations, the net effect would be denial of the net operating losses, which has no justification.

Reclassification of Equity as Debt

It has been suggested that stock issued by loss corporations is often more like debt than equity (because of the financial terms under which such stock is issued). That suggestion is very strained and, more to the point, it is irrelevant in the context of the Ways and Means proposal, which applies to portfolio stock of all corporations. There is no attempt in the Ways and Means proposal to reclassify portfolio stock as debt rather than equity when held by a corporation and to justify reduction of the DRD by such reclassification. If such investments were reclassified as debt, obviously there would be no dividends received deduction, but just as obviously the payor would be entitled to a deduction for interest paid on such "debt." Reclassification of such investments as debt would not raise the total tax on the investment.

Reclassification of purported debt as equity or vice versa is always a legitimate inquiry by the IRS on audit, by the Treasury Department in issuance of regulations, or by the Congress in legislation. That issue is not relevant, however, to the analysis of the need for a DRD.

Conclusion

A reduction in the dividends received deduction is at direct odds with our system of taxing income earned by corporations. One of the results of an erosion of the DRD will be a further distortion of corporate finance, enhancing the bias toward debt and, thus, increasing corporate vulnerability to insolvency and bankruptcy.

Finally, a further reduction in the DRD will affect adversely the issuance of preferred stock, which is a major source of low-cost funding for important sectors of the economy such as thrift institutions, banks, and utilities. For banks and thrifts this is of particular importance today, since preferred stock provides an important layer of equity protecting debt holders and depositors.

STATEMENT OF
O. DONALDSON CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to be here this morning on behalf of the Administration to express our views on certain provisions contained in H.R. 4333, the Technical Corrections Act of 1988, as tentatively marked up by the House Ways and Means Committee. In keeping with the purposes of this hearing, my testimony will focus primarily on provisions in the Ways and Means bill that have not previously been considered by this Committee and certain other provisions of the bill which the Committee has determined to cover in this hearing.

Before proceeding to the specific proposals in the Ways and Means bill, I would like to describe for the Committee our view of the constraints that should limit this Committee's consideration of substantive provisions that go beyond technical corrections to the Tax Reform Act of 1986 ("the 1986 Act") and the Omnibus Budget Reconciliation Act of 1987 ("the 1987 Act"). First, it is imperative that Congress pass technical corrections legislation this year. Such action is necessary to alleviate taxpayer uncertainty and to ensure that the intent of Congress in enacting the 1986 and 1987 tax legislation is carried out. The addition of numerous substantive provisions to the technical corrections bill jeopardizes the prospects for enacting such a bill this year.

Second, we are still not very far down the road from the 1986 Act, which substantially overhauled the federal tax system. As all interested parties have recognized, the system needs a reasonable amount of time to assimilate these changes. Consequently, no major changes in the tax laws are presently in order.

Finally, the President remains firmly opposed to any new taxes, and will not support revenue-raising provisions adopted merely to fund tax relief for some particular group or interest. We hope this Committee will support the President in his determination not to raise taxes on business or working Americans.

The President's budget does propose the extension of Medicare insurance coverage to state and local government employees who began work before April 1, 1986. This is the only major group of employees in the United States who are not participating fully in Medicare. The proposal would eliminate a drain on the Medicare trust fund caused by the fact that most state and local employees are covered by Medicare even though they are not subject to the payroll tax. It would also ensure Medicare benefits to the 25 percent of state and local employees who do not currently receive these benefits.

Although we have proposed extension of Medicare coverage as an appropriate reform of the Medicare system, the proposal also has a positive revenue effect. As I will discuss below, we could recommend to the President certain of the revenue measures marked up by the Ways and Means Committee, where those measures have a sound policy basis and are not designed merely to raise revenue. I should again emphasize, however, that the President's tolerance for revenue measures is very limited, and we will not recommend and do not expect him to support provisions beyond those I will discuss here today.

Given that the legitimate revenue sources available to this Committee will be very limited, it will be necessary for the Committee to carefully limit possible revenue-losing provisions.

Our own priorities in this regard are generally reflected in the budget. We believe it is essential that we continue to stimulate research activities in this country. The encouragement of such activities through an R&E credit and R&E allocation rules plays a strategic role in our country's commitment to technological and competitive leadership in the international community. The budget also proposes a permanent extension of the one-year deferral of the application of the 2-percent floor on miscellaneous itemized deductions to mutual fund shareholders. The President's budget also proposes remedying the so-called "triple tax" problem faced by foreign corporations with both a U.S. branch and U.S. shareholders, and we support recent efforts to develop a domestic election procedure for solving that problem.

Since the budget was prepared, we have become increasingly aware of the burdens imposed by recent changes in the rules relating to the collection of the excise tax on diesel fuel. These burdens are especially pronounced in the case of farmers, who are now experiencing what may be the worst drought since the "Dust Bowl" days of the 1930's. We are pleased to see that the Ways and Means Committee has essentially adopted the relief provision that this Committee adopted in March of this year. We strongly support this relief provision.

We also believe this Committee should give careful consideration to extending the expiring relief provisions for troubled thrifts. As recent months have made clear, the financial problems facing the savings and loan industry and the FSLIC have not diminished. Allowing the relief provisions for troubled thrifts to expire would only complicate the task of restoring the thrift industry to fiscal health.

REDUCE DIVIDENDS RECEIVED DEDUCTION

Background

Under present law, dividends received by domestic corporations from other domestic corporations generally are entitled to complete or partial relief from taxation. The extent of the relief depends upon a number of circumstances, including the relationship between the corporations paying and receiving the dividend. Complete relief generally is allowed for dividends between members of the same affiliated group. In the case of an affiliated group that files a consolidated return, this is accomplished by excluding intra-group dividends from the income of the recipient. In the case of an affiliated (but nonconsolidated) group, intra-group dividends generally are eligible for a 100-percent dividends received deduction ("DRD"). In the case of nonaffiliated corporations, relief from tax on dividend income is not complete. A recipient corporation with so-called "direct" holdings (i.e., ownership of 20 percent or more by vote and value of the stock of the distributing corporation) is allowed an 80-percent DRD. A recipient corporation with so-called "portfolio" holdings (i.e., ownership of lesser amounts of the distributing corporation's stock) is allowed a 70-percent DRD.

A number of special rules limit the benefit of the DRD in certain situations in which allowance of the full DRD is viewed as inappropriate. For example, the ability of recipient corporations to utilize the DRD to avoid paying any tax is limited by section 246(b) and the alternative minimum tax rules. The ability of recipient corporations to gain an "arbitrage" benefit by deducting interest or similar amounts used to finance dividend-paying stock is limited by the debt-financed portfolio stock rules of section 246A and the proration rules applicable to insurance companies. The ability of recipient corporations to manipulate the character of income to take advantage of the differing treatment of dividend income and gain or loss from the sale of stock is limited by the holding period rules of section 246(c) and the extraordinary dividend rules of section 1059.

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Proposal

The Ways and Means bill would reduce the DRD available with respect to portfolio holdings of stock from 70 percent to 55 percent for dividends received in 1989, 51.5 percent for dividends received in 1990, and 50 percent for dividends received in 1991 and subsequent calendar years.1/ No transition relief would be provided for existing stock holdings.

Discussion

Decisions regarding the appropriate level of the DRD address a central issue of corporate taxation -- to what extent will income earned indirectly by an individual through one or more corporations be taxed differently than income earned directly by the individual. Under our tax system, income earned through a corporation is taxed at both the corporate level and the individual level. As a matter of ideal tax policy, the imposition of two levels of tax on income earned through corporations may be questioned. Economists and academicians have argued that the corporate and individual tax systems should be integrated to produce only a single level of tax, and many of our major trading partners provide some degree of integration of their corporate and individual tax systems. In recognition of the tax policy merits of providing relief from double taxation of corporate income, the President's 1985 tax reform proposals to the Congress proposed to allow corporations a partial dividends paid deduction. This tax reform proposal was not enacted, however, and we recognize that, for the foreseeable future, income earned through corporations will continue to be subject to two levels of tax.

Although our tax system fails to provide relief from the double taxation of income earned through corporations, the system has since its inception provided relief from multiple taxation of the same income within the corporate sector. The first federal tax based on corporate income, the Payne-Aldrich Tariff Act of 1909, allowed corporations a 100-percent DRD on the ground that "there is no reason in the world why a corporation that owns stock in another company should pay a double tax on those holdings...." 44 Cong. Rec. 4696 (1909) (remarks of Rep. Payne). Although a DRD was not contained in the Revenue Act of 1913, a 100-percent DRD was reinstituted by the Revenue Act of 1917.

Since that time, the DRD has been retained with only minor changes. The DRD was reduced from 100 percent to 90 percent by the Revenue Act of 1935, and to 85 percent by the Revenue Act of 1936. These changes were intended to offset an anticipated incentive for businesses to divide their income among several corporations to avoid a newly-enacted surtax on income above a certain level and to discourage the formation of holding companies and other complicated corporate structures. Both of these concerns have since been dealt with more directly and effectively.2/ In connection with the limitation of the benefits

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1/ The Ways and Means bill would also revise the threshold for distinguishing between "direct" and "portfolio" holdings of stock. It would provide that the 80-percent DRD is available only with respect to dividends received by a corporation owning more than 20 percent (rather than 20 percent or more) of the distributing corporation. The principal effect of this change would be to preclude any corporation that is a member of an affiliated group from paying dividends qualifying for the 80-percent DRD to any corporation that is not a member of the affiliated group.

2/ Holding companies were regulated by the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940. Multiple surtax exemptions for affiliated corporations were limited by the Revenue Act of 1964 and eliminated by the Tax Reform Act of 1969. Finally, the ability of nonaffiliated corporations to take advantage of multiple surtax exemptions was limited by the Tax Reform Act of 1984, which phased out the benefit of the graduated tax rates for corporations with taxable incomes exceeding $1,000,000, and by the 1986 Act, which reduced this threshold to $100,000.

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of multiple surtax exemptions for affiliated corporations, the Revenue Act of 1964 increased the DRD for affiliated corporations not utilizing multiple surtax exemptions from 85 percent to 100 percent. The DRD for dividends between nonaffiliated corporations remained at 85 percent. The 1986 Act reduced the DRD for nonaffiliated corporations to 80 percent to prevent the 1986 Act's reduction in corporate tax rates from producing a significant reduction in the effective tax rate on intercorporate dividends.

Thus, prior to the 1987 Act, dividends between nonaffiliated corporations had been treated consistently for over fifty years, since the Revenue Act of 1935. The House version of the 1987 Act would have reduced the DRD to 75 percent for all nonaffiliated corporations. The report accompanying the House bill stated that the 80-percent DRD was "too generous for corporations that are not eligible to be treated as the alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation." H.R. Rep. No. 391, 100th Cong., 2d Sess. 1094 (1987). This proposed reduction in the DRD for dividends between nonaffiliated corporations would have represented a significant change in the historical treatment of intercorporate dividends. The 1987 Act, as enacted, however, made an even more significant change in the treatment of intercorporate dividends by introducing a distinction between "direct" and "portfolio" holdings of stock for purposes of the DRD.

The taxation under current law of dividends between nonaffiliated corporations diverges to a minor degree from the pure corporate-solution model of taxation inherent in allowance of a DRD. The further reduction in the DRD proposed in the Ways and Means bill would substantially increase that divergence. The stated rationale of the new House proposal to further reduce the DRD for portfolio holdings is the same as that given by the House in connection with its 1987 proposal to reduce the DRD to 75 percent for all nonaffiliated corporations -- the supposed undue generosity of the current DRD for corporations that are not alter egos. *Description of Possible Committee Amendment Proposed By Chairman Rostenkowski to H.R. 4333*, prepared by the Staff of the Joint Committee on Taxation, June 21, 1988 at 85. This second reduction of the DRD in two years, and the "alter ego" theory that is said to justify the reduction, augurs future erosion -- even the complete elimination -- of the DRD for portfolio stock.

Although the "alter ego" theory has in the past justified a *higher* DRD for dividends between affiliates than for dividends between nonaffiliates, we believe that it does not justify further substantially reducing the DRD for nonaffiliate dividends and discarding the long-standing policy that the same stream of corporate income should not be subject to tax at the corporate level more than once. The combined effect of the 1987 Act reduction and the proposed reduction in the DRD for portfolio stock would be to increase the maximum effective tax rate on intercorporate dividends from 6.8 percent (20 percent of the dividend taxed at the maximum rate of 34 percent) to 17 percent (50 percent of the dividend taxed at the maximum rate of 34 percent). This change would increase the aggregate corporate level tax on this income from 38.49 percent to 45.22 percent. Complete elimination of the DRD for portfolio stock would increase the aggregate corporate level tax to 56.44 percent.

Although the erosion of the DRD for portfolio stock would thus represent a substantial change in a basic tenet of our system of corporate taxation, it appears that this proposal (and the change made by the 1987 Act) were made without consideration of its financial and economic impact. Indeed, revenue considerations seem to be the only force driving this proposal. We strongly believe that a change of this type in a basic principle of corporate taxation should be made only after careful consideration has been given to all its financial and economic effects.

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Any further erosion of the DRD for nonaffiliate dividends may have a number of significant consequences. First, by further encouraging corporations to rely on debt, it will likely alter dramatically the existing balance between equity and debt financing, a balance that arguably already favors debt to too great a degree. This is particularly true, because this change, coming on the heels of last year's legislation, could rationally be taken to indicate that the deduction will soon be completely eliminated.

Further reliance on debt capital may increase the vulnerability of corporations, and the economy as a whole, both to the risks of bankruptcy and to cyclical changes in the economy. Moreover, corporations like banks and financial institutions and utilities that have traditionally relied on corporate shareholders as a source of capital will be affected disproportionately by a reduction in the DRD.

One study shows that of the over $27 billion dollars of preferred stock issued in the years in 1984-1987, approximately 21.7 percent was issued by utilities, 17.5 percent by banks, 14.9 percent by industrials, 7.6 percent by insurance companies and the remaining 38.7 percent by other financial institutions including thrifts. In the case of many of these heavy issuers of preferred stock, the equity raised by preferred stock serves crucial business and financial objectives. For example, banks are required by both national and international regulatory bodies to satisfy minimum capital requirements. See "Banks New Minimum Capital Rules Add to International Banks' Worries," Wall Street Journal, July 12, 1988, p. 17. One study has indicated that in the three year period 1985-87, the U.S. banking industry raised $3.5 billion of equity capital through preferred stock, representing 42 percent of the total equity raised by the banking industry. The manner in which banks currently meet regulatory requirements may thus be significantly altered by the proposed legislation.

Similarly, utilities, which generally have very high capital requirements, historically have relied on preferred stock as an important source of equity. One study has indicated that, in 1987, a group of 100 investor-owned utilities had $27.8 billion of preferred stock outstanding.

The proposed reduction in the DRD would therefore likely increase significantly the cost of equity capital of corporations in these and other industries which have historically relied heavily on preferred stock financing. As a consequence, corporations in these industries will find it more difficult to meet regulatory requirements, or to the extent not constrained by regulatory requirements, will be induced to increase their debt load and, potentially, the financial vulnerability of their capital structures.

In addition, the proposed decrease in the DRD will likely decrease substantially the market value of existing corporate stock because it will reduce the after-tax return realized by corporate investors. This effect will be especially large where, as in the case of most preferred stock, a large proportion of the stock is held by other corporations. The revenue generated by a reduction in the DRD, then, will come largely from current corporate holders of portfolio stock. In addition, the rate at which any reduction in the DRD is phased in may affect the extent of any decrease in the market value of stock. The rate of the phase-in contained in the House proposal, however, appears to have been dictated by revenue considerations and not by concerns regarding the potential market impact of a reduction in the DRD. a market impact that is likely to be a substantial one as is indicated by the reaction of the market since the proposed reduction was first announced in early June.

We recognize the concerns of some that, in certain circumstances, the DRD may serve not merely to provide relief from multiple levels of corporate taxation, but rather to provide

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unwarranted tax benefits. It is certainly appropriate to study and address these issues, and general reduction in the DRD with respect to portfolio holdings may, indirectly, be responsive to these policy issues. The proposed reduction in the DRD would, however, affect all corporations that issue or hold portfolio stock, whether or not allowance of the DRD had any effect other than providing relief from multiple taxation. If Congress ultimately determines that the existing restrictions on the use of the DRD are not adequate, it should consider more targeted measures to strengthen those restrictions.

In conclusion, we believe that the House proposal to reduce the DRD for portfolio stock should not be adopted. Proposed without careful consideration of the consequences, this measure would reverse long-standing and fundamental principles of corporate taxation solely as a revenue-raising measure. We question whether a change of this magnitude can be justified as part of technical corrections legislation and without the foundation of a comprehensive study of its policy merits and financial and economic impact.

REPEAL OF THE COMPLETED CONTRACT METHOD

Background

Pursuant to changes made by the 1986 Act, taxpayers producing property under a long-term contract generally 3/ are required to use either of two methods of accounting: the percentage of completion method or the percentage of completion-capitalized cost method. I.R.C. §460.

Under the percentage of completion method the taxpayer is required to include in gross income in each year of the contract a portion of the contract price based on the percentage of the contract completed by the end of the taxable year. This percentage is determined under the "cost-to-cost" method, and generally is based on the ratio of all contract costs incurred through the end of the year to total expected contract costs.4/ Under the percentage of completion method the taxpayer also deducts contract costs in the taxable year in which they are incurred.

Upon completion of the contract, a "look-back" rule requires the taxpayer to redetermine contract income for each year of the contract based on actual price and costs. The taxpayer is entitled to receive, or required to pay, interest for each year of the contract based on the difference between contract income as originally reported and contract income as redetermined.

The percentage of completion-capitalized cost method is a hybrid method under which the taxpayer is required to report a portion of the contract price and costs using the percentage of completion method. The remaining portion of contract price and costs may be reported using the completed contract method, if that is the taxpayer's "normal method of accounting". Under the completed contract method no amount is includable in gross income, and no contract costs are deductible, until the contract is completed.

3/ The 1986 Act generally does not apply to any construction contract of a taxpayer with average annual gross receipts not exceeding $10 million, if the taxpayer estimates that the contract will be completed within two years. See §460(e).

4/ The Internal Revenue Service has permitted taxpayers to use a simplified method of determining the degree of contract completion under which only certain costs are taken into account. See Notice 87-61, 1987-2 C.B. 370, 373.

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The 1986 Act required that 40 percent of contract income and costs be accounted for under the percentage of completion method, and limited the use of the completed contract method to the remaining 60 percent. The 1987 Act raised the percentage of contract income and costs required to be taken into account under the percentage of completion method from 40 percent to 70 percent, and reduced the percentage allowed to be taken into account under the completed contract method from 60 percent to 30 percent.

In addition to requiring that a portion of income and costs from any long-term contract be taken into account under the percentage of completion method, the 1986 Act also provided new rules for allocating costs to long-term contracts. The general effect of these rules is to require that more costs be allocated to long-term contracts, and therefore to reduce the amount of taxable income that can be deferred under what is left of the completed contract method of accounting.

Under the 1986 Act, all costs, including indirect costs such as administrative expenses, that directly benefit or are incurred by reason of long-term contracts must be allocated to such contracts. This rule effectively applies the cost allocation rules provided by the Tax Equity and Fiscal Responsibility Act of 1982 for extended period long-term contracts to all long-term contracts. In addition, the 1986 Act requires that all costs identified as contract costs under a cost-plus contract or a contract with the Federal Government be allocated to the contract. Finally, the 1986 Act requires that interest costs be allocated to long-term contracts, and therefore deferred to the extent that the taxpayer uses the completed contract method.

Proposal

The Ways and Means bill would, by requiring use of the percentage of completion method for all long-term contracts, fully repeal the completed contract method. This provision generally would apply to all long-term contracts entered into on or after June 21, 1988. The provision would not apply to contracts of small construction companies exempted by the 1986 Act, or to certain ship construction contracts exempted by the 1987 Act.

Discussion

The Administration opposes repeal of the completed contract method. This proposal would again reopen a compromise reached in 1986 in the context of tax reform, and do so solely to raise revenues, rather than for reasons of tax policy. This revenue increase would come at the expense of certain industries that already have experienced an increase in their relative tax burdens as a result of the 1986 Act.

During the process that led to passage of the 1986 Act, the relative merits of the completed contract and percentage of completion methods of accounting for long-term contracts, as well as the need for new cost allocation rules, were thoroughly considered by both the Administration and the Congress. The Administration did not propose repeal of the completed contract method, but instead proposed to limit the potential for deferral of income under the method through expanded cost allocation rules.5/ The tax reform bill passed by the Senate in 1986 would have retained the completed contract method, while providing such expanded cost allocation rules. The tax reform bill passed by the House, in contrast, would have repealed the completed contract method and required use of the percentage of completion method, except for certain construction contracts of small taxpayers.6/ Recognizing that significant policy arguments can

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5/ The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 198-207 (May, 1988).

6/ See H.R. Rep. No. 841, 99th Cong., 2d Sess. II-310-11 (1966).

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be made for and against each method, the Congress arrived at a compromise between the percentage of completion and completed contract methods, which was embodied in the 1986 Act. In order to raise revenues, the 1987 Act reopened this compromise and further restricted use of the completed contract method. The Administration did not support this action.

We believe that any change in current rules governing accounting for long-term contracts should be based on tax policy rather than revenue considerations. Such a change should take place only after a thorough reexamination of this area, including a reexamination not only of the relative merits of the completed contract and cost-to-cost percentage of completion methods, but also of alternatives to these two methods.

SPEED UP CORPORATE ESTIMATED TAXES

Background

Corporations are subject to a penalty with respect to underpayments of estimated income tax liability. I.R.C. §6655. In general, estimated tax payments must equal 90 percent of the tax shown on the return for the taxable year to avoid imposition of the penalty. Under a safe-harbor (not available to large corporations), no penalty is imposed if the estimated tax payments equal 100 percent of the tax shown on the corporation's return for the preceding taxable year.

An additional safe-harbor, available to all corporations, permits the amount of any quarterly estimated tax payment to be based on an annualization of the corporation's year-to-date income. This annualization safe-harbor is intended to allow corporations to estimate their tax liability by reference to events that have occurred prior to the due date of a required payment.

Under current law, any reduction in a quarterly estimated tax payment that results from using the annualization safe-harbor must be partially made up in the next estimated tax payment for the taxable year if the corporation does not continue to use the annualization method in computing the subsequent payment. In such cases, the corporation must increase the amount of the subsequent payment by 90 percent of the shortfall resulting from the prior use of the annualization method to avoid the penalty.

To illustrate the effect of this "recapture" rule, assume that a corporation with a seasonal business has relatively little income during the first part of its taxable year and substantially higher income in the latter part of the year. Assume further that under the general rule, which requires that estimated tax payments equal 90 percent of the tax liability shown on the return for the taxable year, each of the quarterly estimated tax payments would have to be $88,000. Under the annualization safe-harbor, however, the required payments for the first and second quarter would be, say, only $27,000 each. If the corporation did not continue to use the annualization method in its third quarter, its required estimated tax payment of $88,000 for the third quarter would be increased by $110,000 (90 percent of the excess of $176,000 over $54,000). Thus, an underpayment penalty can be avoided if the corporation pays estimated taxes of $198,000 ($88,000 + $110,000) for the third quarter.

Proposal

The Ways and Means bill would require corporations to increase quarterly estimated tax payments by 100 percent (rather than 90 percent) of the reduction in a prior payment that results from using the annualization safe-harbor.

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Discussion

The recapture rule under current law, and under the proposal, applies only if a corporation computes at least one quarterly estimated tax payment using the annualization safe-harbor and does not continue to use the same approach for the remainder of the taxable year. If the taxable income of a corporation is recognized uniformly throughout the taxable year, or if the level of taxable income consistently declines throughout the taxable year, none of the estimated tax payments due will be based on the annualization method. In contrast, if the level of taxable income recognition consistently increases throughout the taxable year, all of the estimated tax payments due will be based on the annualization safe-harbor. Thus, in these circumstances, no recapture is required under current law or under the proposal.

If, however, taxable income recognition levels fluctuate during the taxable year, the recapture rule may increase the amount of an estimated tax payment. This is likely to occur, for example, when taxable income recognition levels start out relatively low, peak during the middle of the year, and decline towards the end of the year. In these circumstances, the first and second quarterly estimated tax payments are likely to be determined under the annualization safe-harbor, while the payments for the third and fourth quarters would be determined under the general rule (*i.e.*, 90 percent of tax liability shown on the return for the year).

Without a recapture rule, a corporation with fluctuating taxable income would be required to pay less estimated tax than a corporation that recognizes its income uniformly throughout the year. This discrepancy is substantially reduced by the 90-percent recapture rule under current law and would be eliminated entirely by the 100-percent recapture rule under the proposal. We see no reason why a corporation that uses the annualization method for only part of the year should not be required to make up any shortfall completely when it ceases to use that method.

REPEAL RULES PERMITTING LOSS TRANSFERS BY ALASKA NATIVE CORPORATIONS

Background

Under present law, Alaska Native Corporations ("ANCs") are exempt from several rules that limit the ability of loss corporations to sell or otherwise transfer their losses to other corporations. These exemptions began with the Tax Reform Act of 1984, which amended Code section 1504(a) to tighten the definition of affiliated groups eligible to file consolidated returns, but which also delayed the effective date of this change until taxable years beginning after 1991 in the case of affiliations with ANCs.

The 1986 Act further liberalized the requirements for affiliation with an ANC (or with a wholly-owned subsidiary of an ANC) for any taxable year beginning after 1984 and before 1992. In particular, the 1986 Act made it clear that no provision of the Code (*e.g.*, sections 269 and 482) or principle of law (*e.g.*, the assignment of income doctrine) may be applied to deny the benefit or use of losses or credits of an ANC which is the common parent of an affiliated group, or of a wholly-owned subsidiary of such an ANC, to the group. Thus, as so liberalized, affiliation with an ANC is to be determined solely according to the provisions expressly contained in section 1504(a) of the Code as it existed before the amendments made by the 1984 Act.

Proposal

The Ways and Means Committee proposal would terminate the exemption of ANCs from the generally applicable current law rules for losses and credits of an ANC (1) arising after April 26,

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1988, or (2) arising on or before April 26, 1988 to the extent such losses and credits are used to offset income assigned (or attributable to property contributed) after that date. This proposal is identical to H.R. 4475 as introduced by Chairman Rostenkowski on April 27, 1988.

Discussion

The exemption of ANCs from the general rules applicable to loss corporations was intended to provide special relief to ANCs with large net operating losses and numerous business credits that they would not otherwise have been able to use. This relief was designed to allow losses and credits of an ANC and its wholly-owned subsidiaries to be used on a consolidated return against the income and tax liability of profitable corporations and to allow the ANC group to share in the resulting economic benefits. It was hoped that the resulting infusion of capital would help improve the financial condition of ANCs and that resulting relationships with other corporations would permit ANCs to acquire new business expertise.

As a tax policy matter, these special provisions have always been controversial, and the tension between this provision and sound tax policy has increased over the last several years. Recent tax legislation has severely curtailed the ability of one corporation to transfer its losses and credits to another. In particular, transfers between corporations have been restricted by (i) the amendments relating to the definition of an "affiliated group" in section 1504 of the Code, (ii) the revised limitations on net operating losses and certain built-in losses following an ownership change in section 382, and (iii) the limitation on the use of preacquisition losses to offset built-in gains in section 384. In light of these changes, the continuation of special rules that permit certain taxpayers to sell losses and credits without regard to any provision of the Code or principle of law that would otherwise restrict such a transfer is unjustifiable.

Although it appears that there may have been some success in achieving the goals underlying this relief provision, it also appears that the losses and credits available to be transferred, and that have been transferred, far exceed the estimates made at the time these special relief provisions were adopted. Now that it is clear that the associated revenue costs greatly exceed Congress's expectations, it is appropriate to terminate this relief.

The proposal would, in effect, prevent ANCs from engaging in any transactions after April 26, 1988 that would have the effect of transferring their losses or credits, whether such losses or credits arose before or after such date, to another corporation (except to the extent permitted by the generally applicable rules). In addition, this proposal would affect certain transactions entered into before such date if the losses or credits "arise" after such date. It is unclear, however, whether a loss arises for purposes of this proposal when it is realized and recognized for tax purposes or when it is economically incurred. For this reason, the time at which losses are deemed to arise under the proposal should be clarified.

This proposal would also prevent ANCs from transferring losses or credits arising on or before April 26, 1988 to the extent such losses or credits are used to offset income assigned (or attributable to property contributed) after that date. It apparently would not prohibit transfers of such losses and credits to the extent they are used to offset income which is actually earned after that date as long as the income was assigned (or the property to which it is attributable was contributed) before April 26, 1988. This "grandfathering" of transactions involving income actually earned after April 26, 1988 may result in further revenue losses. It may also be

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perceived as unfairly benefiting those ANCs that had already completed transactions transferring their losses and credits as opposed to those that had not yet completed such transfers. For these reasons, consideration should be given to expanding the proposal to apply to all income earned after April 26, 1988.

NONDISCRIMINATION RULES FOR HEALTH AND OTHER EMPLOYEE BENEFIT PLANS

Background

As part of the 1986 Act, with Administration support, Congress adopted rules limiting the extent to which employer-provided health, group-term life insurance, and certain other employee benefit plans may discriminate in favor of an employer's highly compensated employees. Satisfaction of these new nondiscrimination rules, which are contained in section 89 of the Code, is a precondition to the exclusion by the employer's highly compensated employees of such tax-favored benefits from income. The requirements of section 89 are not yet in effect; they will be effective for taxable years beginning after the earlier of (i) the date that is three months after Treasury issues certain regulations, or (ii) December 31, 1988.

Section 89 requires not only that the health and other benefits be available to employees on a nondiscriminatory basis, but also that actual receipt of benefits be nondiscriminatory. In general, an employer's health and other benefit plans are nondiscriminatory if (i) at least 90 percent of the employer's nonhighly compensated employees have benefits available that are at least 50 percent as valuable as the benefits available to the highly compensated employee with the most valuable benefit available, and (ii) the per capita average value of the benefits actually provided to the nonhighly compensated employees is at least 75 percent of the analogous per capita average for the highly compensated employees. Application of the section 89 rules requires that the benefit coverages provided by an employer be valued and that data on the family status of employees and the actual coverage received by employees and their families be collected and analyzed.

Proposal

In response to many of the concerns raised by employers about the difficulty of proving compliance with the section 89 rules, the Ways and Means bill would make numerous changes to section 89.

Discussion

In our view, any changes to the section 89 rules should be consistent with the nondiscrimination policy reflected in the original rules and should address specific administrative concerns raised by employers within the structure of the existing rules; changes that would create new testing approaches or otherwise add additional administrative complexity for employers or the IRS should be avoided. In addition, any changes that affect not only section 89, but also the nondiscrimination rules applicable to qualified retirement plans (e.g., changes to the highly compensated employee definition) must be carefully scrutinized to assure that pension policy objectives are not being frustrated. In certain circumstances, it may be appropriate to provide that such changes apply only for purposes of section 89.

We believe that the proposed changes generally satisfy these guidelines, and we generally support them. In fact, we have been considering many similar changes in developing administrative guidance on the new rules.

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Among the most significant of the proposed changes is the transition valuation rule permitting employers to use any reasonable method of health coverage valuation (including employer cost) until the later of January 1, 1991 or 6 months after the IRS issues valuation rules. The existing statute directs employers to determine the value of health coverage in accordance with guidelines and tables issued by the IRS. However, developing generic value guidelines and tables has proven to be a difficult task that we are not likely to complete within the next 12 months. Thus, this change will enable employers to prove compliance with the nondiscrimination rules by using value or cost information that will in most cases be accessable with little difficulty.

Another very significant change is the rule permitting employers to prove compliance with the nondiscrimination rules by testing the benefits available and provided on a single day of the year, subject to appropriate anti-manipulation rules, instead of tracking benefit availability and coverage for each day of the year. By also permitting employers to prove compliance on the basis of a statistically valid sample of employees and coverages, rather than on the basis of data collected on all employees and coverages, the proposed changes eliminate what may have been the gravest administrative concern raised by employers--the difficulty and cost of collecting and analyzing employee and benefit data for each employee for each and every day of the year.

Finally, we would like to mention one particular issue that is not directly addressed in the Ways and Means bill, but that we are aware is a matter of some concern to employers. The issue relates to the extent to which employers will be able to apply section 89 on a separate line of business or operating unit basis (section 414(r)). Employers evidently are concerned that the line of business regulations we are developing will not permit sufficient disaggregation of an employer into separate units based on geographical areas.

We are aware that special concerns relating to health benefits argue strongly for permitting the disaggregation of an employer into small, geographically based units for section 89 testing purposes (e.g., health plans and costs vary significantly by geographical area and the health nondiscrimination rules apply on a per capita, rather than a percentage of compensation, basis). Consistent with these concerns, we intend to provide early guidance under section 89 that will specifically address the extent to which employers may separately apply the new rules with respect to separate geographical sites. This guidance will generally permit disaggregation beyond that permitted under section 414(r). Also, an employer will be able to apply these special section 89 disaggregation rules even before section 414(r) guidance is issued.

EXTENSION FOR ONE YEAR OF THE LOW-INCOME HOUSING TAX CREDIT

Background

The 1986 Act created a low-income housing tax credit which may be claimed by owners of residential rental property used for low-income housing. I.R.C. §42. The credit is intended to encourage investment in rental housing for individuals near the poverty level. The credit is set to expire on December 31, 1989.

New construction and qualified rehabilitation expenditures for non-federally subsidized low-income housing units are eligible for a tax credit of up to 70 percent of the initial low-income housing investment. The owner of a qualified project receives a portion of the credit each year over a 10-year period, and the amount of each annual credit is grossed-up so that the sum of the credits received equals 70 percent of the investment on a present value basis. If tax-exempt bond financing or certain other government subsidies are used to finance the

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project, then a 30 percent credit rate applies. Purchases of existing units that were last placed in service more than 10 years ago are also eligible for a 30 percent credit.

The credit is available only for units rented to households near or below the poverty level. In general, a project owner can choose one of two minimum qualifying criteria: (1) 40 percent of units must be rented to households whose incomes do not exceed 60 percent of area median income, or (2) 20 percent of the units must be rented to households whose incomes do not exceed 50 percent of area median income. In addition, the amount of rent charged for the low-income units is subject to certain limitations.

Designated state agencies authorize credits to qualifying projects subject to an overall cap of $1.25 per capita of new annual credit authority per year. In 1987, the total credit authority was approximately $300 million. States generally may not carry over unused credit authority. A limited exception is provided for buildings placed in service in 1990, if expenditures equal to 10 percent or more of total project costs are incurred before January 1, 1989. Credit authority for such property may be carried over from the 1989 credit allocation for the credit agency.

A full or partial recapture of the credit is applicable with respect to any project that (i) fails to provide the agreed upon percentage of low-income housing units, (ii) exceeds qualifying rent limits, or (iii) is transferred without the posting of a suitable bond. For projects that fail to comply in the first 11 years, one-third of the credit is recaptured with interest. The recapture fraction phases out between years 12 through 15.

The technical correction bills in both the Senate (S. 2238) and the House (H.R. 4333) contain the same technical corrections provisions relating to the low-income housing credit. These changes are primarily technical in nature and are needed to make the credit more effective and easier to use. Treasury generally supports the entire package of technical corrections to the credit proposed by both the House and the Senate. Passage of a technical corrections bill is an important step to ensure proper utilization of the credit.

Proposal

In addition to the numerous technical corrections provisions, the Ways and Means Committee has agreed to extend the credit for one year to December 31, 1990. The extension of the credit this year is intended to help ensure the continued use of this housing subsidy while Congress has an opportunity to gather more information on its operation and relative efficiency before deciding to continue, modify, or eliminate the credit. No changes to the credit have been proposed by the Ways and Means Committee to offset the revenue cost of a one-year extension of the credit.

Discussion

The Administration is opposed to extending the low-income housing credit for one year. The credit does not expire until the end of 1989, and it is thus premature to enact a one-year extension of the credit this year. Developers can continue to plan low-income projects with the assurance that credits will be available so long as the project is (i) placed in service before the end of 1989, or (ii) placed in service in 1990 and 10 percent or more of total project costs are incurred before January 1, 1989. Thus, we believe that development and construction of low-income projects will continue this year without an extension of the credit.

More importantly, we believe that it is critical that the relative efficiency of the current credit and alternative housing subsidies be fully analyzed before any decision is made to extend

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the credit. Even a one-year extension of the credit is an expensive proposition because credits are allowed in each of the next ten years. Thus, a one-year extension means a significant revenue cost each year for ten years. While the current revenue cost of the low-income housing tax credit is estimated to be $60 million in calendar year 1987, the cost grows to around $800 million in fiscal year 1991 as a result of increased usage of the credit and the continued payment of credits for 10 years on earlier projects. We estimate that the cost of a one-year extension of the credit would be $.8 billion over 5 years.

While the low-income housing credit is a clear improvement over prior tax incentives for low-income housing, we have serious concerns about the efficiency and equity of the credit that require a further examination of the credit before it is extended. First, would some subsidized units simply replace units that would have been available in the absence of federal assistance? If so, the credit may not result in a significant long-run increase in housing supply. Second, the credit includes no incentive for maintenance. If units receiving the credit rent at below market levels, will landlords allow the projects to deteriorate without losing tenants? In addition, without additional subsidies, will project owners have any economic incentive to continue to rent to low-income tenants after the compliance period elapses? Finally, will households substantially below the poverty level benefit from the credit?

Another source of inefficiency of the credit is that it may not result in housing of a quality or location that is appropriate for or desired by low-income renters. Thus, even if the full value of the credit were passed along to low-income tenants, the value to the renter would be less than the amount of the subsidy.

The Administration has addressed many of these concerns by reemphasizing its commitment to rental housing vouchers in the 1989 budget. Vouchers avoid many of the inefficiencies discussed above. The budget proposes to provide 135,500 additional vouchers to needy households. In light of the relative efficiency of vouchers, we oppose making the low-income housing credit the dominant mechanism for assisting low-income housing. In this regard, we look forward to working with Congress to determine the best method of providing housing assistance to poor families.

ESTATE FREEZES

Background

The 1987 Act added section 2036(c) to the Code in an effort to remove the tax advantages of various techniques designed to "freeze" the value of an estate for federal estate tax purposes. These techniques involve a transfer of the right to appreciation in an asset with the owner retaining an income interest in the asset or rights to control the asset. A typical "estate freeze" consists of parents transferring common stock in the family business to their children while retaining control of the corporation, and a right to the corporation's income, through ownership of preferred stock. The effect of section 2036(c), where it applies, is to treat the owner as retaining the transferred interest and to include that interest in the owner's estate.

Section 2036(c) applies to any transfer occurring after December 17, 1987, if the transferor holds a substantial interest in an "enterprise" and in effect transfers property having a disproportionately large share of the potential appreciation in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise. The Conference Report describes an "enterprise" as including any business or other property which may produce income or gain. A person holds a "substantial interest" in an enterprise if he or she owns, directly or indirectly, 10 percent or more of the voting power or income stream, or both, in the enterprise. An individual is treated as owning an interest in an enterprise which is directly or indirectly owned by any member of an individual's family.

Section 2036(c) excludes from the decedent's gross estate an interest that is transferred in a bona fide sale for full and adequate consideration. However, this exception is not applicable to a transfer between family members if the transfer otherwise satisfies the criteria of section 2036(c). In addition, section 2036(c)(4) provides that if a transferor disposes of his retained interest within three years of his death, the previously transferred interest will be included in his estate for Federal estate tax purposes.

Under the current statute, a transferred interest is includible in the transferor's estate (and valued as of the time of the transferor's death) regardless of whether the transferee transfers his interest in the enterprise (or whether proportionality is restored) before the death of the transferor. However, if the transferor disposes of his retained interest more than three years before his death, or it is otherwise terminated before that time, section 2036(c) does not apply.

The technical corrections bills in both the House (H.R. 4333) and the Senate (S. 2238) contain identical rules imposing a gift tax when the original transferor transfers the retained interest, or the original transferee transfers the transferred property, to a person who is not a member of the original transferor's family. Under this proposed technical correction, the amount that would have been included in the transferor's estate with respect to the transferred property if the transferor had died at that time would be treated as a current gift by the transferor ("the deemed gift rule"). Section 2036(c) would then no longer apply to that transferred property for estate tax purposes. If the transferor or transferee transfers only a portion of the retained or transferred interest, respectively, a proportionate amount of the interest would be treated as a deemed gift under this rule.

Proposal

In addition to the proposed technical corrections in H.R. 4333 and S. 2238, the Ways and Means Committee has tentatively adopted additional technical corrections which further clarify and broaden both the original statute and the first set of proposed technical corrections. For example, the Ways and Means bill provides that for purposes of the deemed gift rule described above, terminations, lapses and other changes in any interest in property of the transferor or transferee are treated as transfers. The bill also confers upon the transferor a right of contribution similar to that of section 2207A 7/ and provides the Treasury Department with authority to describe circumstances in which an individual and such individual's spouse will not be treated as one person.8/

7/ Under section 2207A, a surviving spouse's estate is granted a right to recover from the recipients of certain property the estate taxes paid as a result of the inclusion of the property in the spouse's estate.

8/ This rule is intended to prevent the inclusion of interests in property under section 2036(c) in both spouses' estates where there is a transfer of the retained interest between spouses.

The Ways and Means bill includes safe harbors for certain common business transactions that otherwise might be reached by section 2036(c). For example, the bill provides that section 2036(c) will not apply solely because the transferor receives or retains certain debt of the enterprise. Further, the statute would not apply solely because the transferor enters into an agreement for the sale or lease of goods or other property to be used in the enterprise, or the providing of services, if the agreement is an arms-length agreement for fair market value and does not otherwise involve any change in interests in the enterprise. Finally, the bill provides that section 2036(c) will not apply merely because the owner has granted an option to sell property at fair market value as of the time the option is exercised.

Discussion

Section 2036(c) is designed to remedy the perceived unfair estate tax advantage resulting from the creation and transfer of fractional interests in an enterprise with different rights to income, voting control and appreciation. The creation and transfer of such interests may arguably result in the transfer of wealth outside the transfer tax system in certain situations.

In general, the purpose of the proposed "deemed gift" technical correction in the first set of technical corrections is twofold. First, it is designed to impose the tax on the value of the transferred interest at the time that the transferee disposes of the transferred property or the transferor disposes of the retained property (or when proportionality is restored). Second, it is designed to prevent the complete avoidance of the consequences of section 2036(c) by subsequent transfers more than three years before death.

Both sets of technical corrections to section 2036(c) are very broad in scope. While some of the technical corrections are necessary to clarify the statute and provide safe harbors to taxpayers who might otherwise be affected by section 2036(c), we are concerned that they are considerably broader than the perceived abuse would require.

We are also concerned whether further tightening of these rules which has the effect of increasing taxes on estates is warranted without further study. The Treasury Department is interested in exploring whether additional safe harbors or further guidance can or should be provided either by legislative or administrative action. In this regard, we look forward to working with this Committee to improve this provision and provide needed guidance as soon as possible.

There is one other provision in the House bill -- the so-called "residual treaty override" -- which is of such far-reaching and fundamental significance to our tax policy and tax law that I must ask for forebearance for a few moments in order to comment on it here, even though I have testified on the treaty override provision before.

RESIDUAL TREATY OVERRIDE

Background

In my statement before the Subcommittee on Taxation and Debt Management last July 22 on the then-pending technical corrections bill, I explained that the Administration strongly opposes the provision in the technical corrections bill that purports to "clarify" the relationship between income tax treaties and provisions in the 1986 Act. This provision, section 112(aa)(2)(C) of the Technical Corrections Act of 1988 introduced in the Senate and the House of Representatives on March 31, 1988, remains in the bill tentatively approved by the House Ways and Means Committee. I am not asking now, as I did before, that the Committee eliminate this provision altogether. Instead, I would

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strongly urge the Committee to consider modifying this provision so that it addresses the concerns that Congress and the Administration share regarding the relationship between treaties and tax legislation, but does so in a manner that does not needlessly and gratuitously undermine the standing and credibility of the United States as a treaty partner.

Description of Section 112(aa)(2)(C) of H.R. 4333.

Section 112(aa) of the technical corrections bill attempts to provide definitive rules for the coordination of provisions in the 1986 and 1987 tax legislation and pre-existing treaties. The approach taken is to identify provisions in the recent tax legislation that are thought to conflict with one or more income tax treaties and to specify those provisions that would not apply to the extent inconsistent with pre-existing treaties and those that would override U.S. treaty obligations. In addition, section 112(aa)(2)(C) provides that, in any other cases of conflict between the two recent tax Acts and treaties, the Acts' provisions are to apply notwithstanding any treaty obligation of the United States.

Discussion

During Congress's consideration of the 1986 Act, the Administration made clear its opposition to the several treaty overrides contained in that legislation. Our view then, and now, is that treaty overrides are neither necessary nor appropriate. Today, however, I do not want to restate old arguments, but rather to focus solely on the residual override in section 112(aa)(2)(C).

In the 15 months since a residual override was first proposed by congressional staff, we have regularly discussed with your staffs the importance of treaties and the importance of ensuring that treaties and tax legislation are interpreted in a manner that is consistent with the intent behind both the legislation and treaties. Significantly, there is agreement on many important points:

-- There is agreement that courts generally have done a good job of reconciling statutes and treaties by applying canons of construction developed in the process of two centuries of judicial decisionmaking.

-- There is agreement that courts do and should seek to avoid finding a conflict between statutes and treaties whenever possible, so that effect can be given to both.

-- There is agreement that, in interpreting statutes and treaties, courts do and should consider the intent of Congress and the Administration in enacting the legislation and entering into the treaty.

-- There is agreement that taxpayers should not be permitted to use treaties in ways not intended by the treaty partners to prevent application of general tax provisions enacted by Congress.

Regrettably, the residual override -- as currently drafted -- would make it more difficult for courts to reconcile statutes and treaties in a manner that gives effect to the purposes of both. In the case of presently unidentified conflicts between statutes and treaties, the residual override expresses a congressional intent that the legislation be given effect over pre-existing treaties in every case. Courts are simply instructed to make the treaty yield to the later-enacted statute.

As I stated in my testimony last year, we believe that for the non-judicial branches of government to insist that courts blindly apply the later-in-time doctrine reflects a lack of confidence in courts and a lack of regard for treaties. It also

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denies both the United States and its treaty partners the benefit of case-by-case consideration of how purported conflicts should be resolved on their merits, in light of the respective purposes and policies intended to be served by the treaties and the relevant legislation.

Although the Administration strongly opposes the residual override as it is currently drafted, we believe the attention that has been given to the interaction of statutes and treaties can lead to productive change. We recognize and share the concerns expressed by congressional staffs that taxpayers not be permitted to misinterpret or misapply treaties in a manner that prevents appropriate application of the many important tax changes included in the recent tax legislation. We agree with congressional staffs that misuse of treaties, if permitted, can undermine the respect for treaties that is essential to an effective treaty network. At the same time, we sense broad agreement in Congress that income tax treaties are an important benefit for our multinational taxpayers and for the U.S. economy and thus should be preserved and strengthened.

Accordingly, we are now in the process of discussing with your staffs and the staff of the Joint Committee on Taxation an alternative to the residual treaty override that would give appropriate weight to treaties but would also ensure that treaties are not misused to undermine congressional intent in enacting tax legislation.

I urge you to reconsider the residual treaty override of section 112(aa)(2)(C) and amend the provision appropriately. We -- Congress and the Administration -- are presented with a significant opportunity. Deleting the residual override as it is currently drafted and substituting a suitable alternative will reaffirm to treaty partners that the United States takes its treaty commitments seriously and values its treaty network. It will deter our treaty partners, many of whom are undergoing their own tax reform following the United States' lead, from unilaterally overriding our tax treaties to the detriment of United States taxpayers and interests. It will remove a significant impediment in our international relations that has adversely affected our tax treaty program and has even spilled over into international relationships on other issues. In addition, appropriate amendment to this provision will strengthen the Executive Branch's ability to carry out the responsibility given it by Congress to implement in our tax treaties the many important changes in tax law and policy established by the 1986 and 1987 Acts.

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PREPARED STATEMENT OF GLENN GRAFF

ASSOCIATED GENERAL CONTRACTORS OF AMERICA
TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE
WEDNESDAY, JULY 13, 1988

The Associated General Contractors appreciates this opportunity to comment on the Technical Corrections Act of 1988.

AGC urges that Congress make no changes to the method of accounting for long-term contracts this year so that the construction industry and accounting practitioners have a chance to adapt to the major changes made in 1986 and 1987.

If Congress does decide to once again amend the long-term contract accounting rules, AGC requests that Congress address the problems that the construction industry is encountering in implementing the new rules.

AGC believes that the interests of simplification and fairness to small business can best be served by repeal of the lookback rule under the percentage of completion method of accounting. Its implementation is costing the construction industry millions of dollars, yet the provision was designed so that it would not raise any extra tax revenue. The lookback method requires literally thousands of calculations to be done on each contract for every year whenever costs or revenues change.

AGC requests that the exception for small contractors be conformed to the Small Business Administration's definition of a small or a small disadvantaged construction contractor.

AGC requests that the effect of state lien laws and trust fund statutes be taken into account in defining when gross income is realized on a contract. Retained amounts should not be considered income until the contractor receives the right to receive the income.

My name is Glenn Graff. I am the chief financial officer for Linbeck Construction Corporation in Houston, Texas. I am here today on behalf of the Associated General Contractors of America, for whom I am the chairman of the Tax and Fiscal Affairs Committee.

The construction industry has been hit hard by two major tax law changes in two years. The changes to the method of accounting for longterm contracts in 1986 brought widespread confusion to both the construction industry and the accounting practitioners working with the industry. In 1987, as construction firms struggled to implement the new 1986 law, they were again hit by a change to the method of accounting for longterm contracts.

The administrative difficulties that the construction industry is encountering as firms struggle to implement the new rules resulting from these changes are far greater than the industry or the government estimated. Generally, large and small firms are finding that the amounts they are paying to have their tax returns prepared this year are at least double and generally more than double what they were in previous years. For example, I know of one construction firm that paid nearly $100,000 for preparation of its 1987 federal tax return, approximately double the cost of the prior year.

If the rules for longterm contract accounting are amended again this year, contractors will be faced with using three different methods of accounting for longterm contracts. AGC urges the Congress to make no changes to the method of accounting for longterm construction contracts this year so that the construction industry and accounting practitioners have an opportunity to adapt to the changes already made.

If Congress does decide to once again amend the longterm contract accounting rules, AGC respectfully asks the Congress to address certain problems that construction firms are encountering in trying to carry out the new percentage of completion method (PCM). These problems center around implementation of the lookback rule. A number of proposals have been offered to correct the problems construction firms are having in their attempts to implement this new rule, but many problems remain unaddressed.

AGC believes that the interests of simplification and fairness could best be served by repeal of the lookback method. It is important to note that the Joint Tax Committee staff has said repeatedly that the lookback method is "revenue-neutral." That may be true as far as the goverment is concerned. However, the lookback rule will cost the construction industry millions of dollars annually, while generating not one extra dollar of tax revenue -- a perfect "lose-lose" situation.

These additional costs stem from what for most construction firms will be thousands of additional calculations. In the year a longterm construction contract is completed, the construction firm must go back and substitute for each year the contract was in progress the actual costs and revenues for the estimated costs and revenues used in prior years' tax computations; then taxes for all prior years must be recalculated for both alternative minimum tax and regular tax purposes; next the difference between the taxes actually paid each year and the taxes that would have been paid each year had actual costs been used must be calculated; and finally, daily compounded interest subject to rate change on a quarterly basis must be calculated on the difference to determine whether interest is owed to or due from the government.

This "lookback" rule has proven to be an administrative and accounting nightmare in practice for construction firms both large and small. A construction contractor can spend literally thousands of dollars to discover whether they should receive $10 from the IRS.

For example, a construction contractor in Georgia had gross receipts for his 1987 taxable year of $10.3 million. Therefore, he did not fit the "small contractor" exception. He had 30 contracts open at the end of his taxable year. Under the percentage of completion method (PCM), each one of those contracts was subject to the lookback provision. The largest contract was for $1.9 million; the smallest was for $600.

Because the $600 contract was not completed during the taxable year, it was by definition a "longterm contract" and subject to the lookback rule. This contractor's accountants made the lookback computations and determined the contractor was due $1.35 in interest on the $600 contract. The contractor paid nearly $20,000 for the preparation of his tax return, approximately the same cost as his company's audit for the entire year.

Construction contracts unfortunately do not always finish in a neat and orderly fashion. Increments of both costs and revenues related to a contract may continue to "dribble in" on a sporadic basis for years. For example, the contractor may return to the project to do warranty work, or workers' compensation premiums may be retrospectively calculated for years after the contract ends. The lookback rule requires all of the calculations I previously noted to be redone each year on every contract that has additional revenue or costs. As a result, construction contractors could be forced to keep these small contracts open for years after the contracts are substantially completed.

Claims and lawsuits often arise in the normal course of construction and are settled after negotiations, arbitration or court action. Under the new percentage of completion method, recoveries from claims and lawsuits are subject to the lookback rule, and in instances where disputes are not settled for a number of years -- a common occurrence -- the tax and interest due may well be greater than the recovery.

Another shortcoming of the lookback provision is its unequal application to taxpayers. For example, a California construction contractor and a supplier were involved in a dispute with an owner. After several years of litigation, the contractor and the supplier received an award. Both companies had been in the identical position; both recovered equally. In this example, under the new PCM rules, the supplier would take his recovery into income in the year received, while the contractor's recovery would be subject to the lookback provision and he would pay interest from the year the project started through the recovery date.

Current law contains a "carve-out" for small construction contractors. Contractors may continue to use the completed contract method if the contract will be completed in two years and the contractor's average annual gross receipts for three years do not exceed $10 million. AGC most respectfully requests that the carve-out amount be increased to $17 million, which is the Small Business Administration's current size standard for small and small disadvantaged construction firms. This would allow other small and small disadvantaged construction companies that would otherwise fit the current exemption but for the receipts of affiliated concerns to use the completed contract method of accounting.

Should Congress decide to again consider changes to the method of accounting for longterm contracts, AGC also respectfully requests that Congress examine another serious problem associated with PCM.

A study of the profit margins of construction firms by V.B. Castellani & Co., Inc. discloses that net profit for construction companies ranges from 0.1% to 1.6%. In many instances this scant profit is not realized until after the project is completed because of the retainage factor. Frequently state lien laws require owners to withhold up to 10% of the amount of the contract in order to protect the construction project from liens of subcontractors and suppliers. Under PCM as it now stands, those retained amounts are subject to taxation long before the construction contractor actually receives them. There has been a myth that construction contractors often receive large advance payments under "front-end" loading techniques, and therefore have funds available to pay taxes before the contract is complete. The reality is that many states have trust fund statutes that require a construction contractor to use any such advance payments with respect to contracts only for the purpose of paying materials, labor and subcontract costs for that specific contract. These funds cannot be used to pay income taxes.

Accordingly, AGC believes that in the interests of equity and fairness, these retained amounts should not be considered income until the end of the contract when the construction contractor has the right to receive them.

Mr. Chairman, this concludes my statement.

RECORDED IN PRIOR YEARS				TAXABLE IN 1986				DEFERRED TAXABLE INCOME @ 12/31/86 USING 40% PCM				
									COST			
REVENUE	DIRECT COST	ALLOCATED COST	PROFIT	REVENUE	DIRECT COST	ALLOCATED COST	PROFIT	REVENUE	DIRECT	ALLOCATED	TOTAL	PROFIT
N/A	N/A	N/A	N/A	46	40	1	5	69	60	1	61	7
N/A	N/A	N/A	N/A	36	32	1	2	53	48	2	50	4
N/A	N/A	N/A	N/A	37	28	3	6	56	42	5	47	9
N/A	N/A	N/A	N/A	35	32	2	1	52	48	3	51	1
N/A	N/A	N/A	N/A	47	40	2	5	70	60	3	63	7
0	0	0	0	200	172	9	19	300	258	14	272	28
N/A	N/A	N/A	N/A	48	40	1	7	72	60	1	61	10
N/A	N/A	N/A	N/A	44	32	1	11	67	48	2	50	17
N/A	N/A	N/A	N/A	59	28	3	28	89	42	5	47	42
N/A	N/A	N/A	N/A	42	32	2	8	64	48	3	51	13
N/A	N/A	N/A	N/A	62	40	2	20	93	60	3	63	30
0	0	9	0	256	172	9	74	384	258	14	272	112

DIFFERENCE WITHOUT ROUNDING TO THOUSANDS	HYPOTHETICAL TAX AT 46% (WITHOUT ROUNDING)	INTEREST @ 8% WITHOUT ROUNDING TO THOUSANDS *
2,030	934	75
8,939	4,112	329
21,689	9,977	798
7,713	3,548	284
15,361	7,066	565
55,733	25,637	2,051

* COMPOUNDED DAILY

NOTE : PRESUMABLY, THERE WOULD ALSO BE AN ADJUSTMENT TO REFLECT THE CHANGE IN THE TAX RATE BETWEEN 1986 & 1987. PRESENT LAW IS NOT CLEAR ON HOW THIS WOULD WORK.

These three charts show five sample contracts and the calculation of lookback interest on the contracts. The charts do not reflect the hundreds of calculations that had to be done just to achieve these numbers. They show the actual costs to date, the estimated costs and profit, what the balance should have been and the difference. The final column on the third chart shows the total lookback amount to be $2,051.

CLOSED CONTRACTS

SAMPLE CONSTRUCTION CORPORATION

4-1 PCM CONTRACTS (STARTED AFTER 2/28/86)

FOR THE YEAR ENDED DECEMBER 31,1987
(000)

		ACTUAL COST TO DATE						ESTIMATED COST AT COMPLETION					JOB TO DATE TAXABLE PROFIT				RECOGNIZED IN PRIOR YEARS				TAXABLE IN 1987			
			ALLOCABLE COSTS																					
JOB #	CONTRACT VALUE	DIRECT COSTS	ALLOCABLE COSTS 1986	ALLOCABLE COSTS 1987 *	SUBTOTAL ALLOCABLE COSTS	TOTAL COST	DIRECT COST	ALLOCATED COST	TOTAL COST	% COMPLETE @ 12/31/87	ESTIMATED PROFIT @ COMPLETION	REVENUE	DIRECT COST	ALLOCATED COST	PROFIT	REVENUE	DIRECT COST	ALLOCATED COST	PROFIT	REVENUE	DIRECT COST	ALLOCATED COST	PROFIT
6222	220	160	2	26	28	188	160	28	188	100.0	32	220	160	28	32	46	40	1	5	174	120	27	27
6700	130	80	3	14	17	97	80	17	97	100.0	33	130	80	17	33	36	32	1	3	94	48	16	30
6899	367	153	8	33	41	194	153	41	194	100.0	173	367	153	41	173	37	28	3	6	330	125	38	167
6969	703	449	5	110	115	564	449	115	564	100.0	[illegible]	703	449	115	139	35	32	2	1	668	417	113	138
6970	1,200	658	3	136	141	799	658	141	799	100.0	[illegible]	1,200	658	141	401	67	60	2	5	1,133	598	139	396
TOTAL	2,620	1,500	21	319	342	1,842	1,500	342	1,842		778	2,620	1,500	342	778	221	192	9	20	2,399	1,308	333	758

* FROM EXAMPLE 2 - REPRESENTS THE SUMMATION OF THE COLUMNS ENTITLED "INDIRECT COSTS" & "HOME OFFICE OVERHEAD".

CALCULATION OF
LOOK BACK INTEREST

SAMPLE CONSTRUCTION CORPORATION

40% PCM CONTRACTS (STARTED AFTER 2/28/86)

FOR CONTRACTS COMPLETED IN 1987
CALCULATION OF PROFIT WHICH SHOULD HAVE BEEN REPORTED IN 1986
(000)

	JOB #		CONTRACT VALUE	ACTUAL COST TO DATE						ESTIMATED COST AT COMPLETION			% COMPLETE @ 12/31/86	ESTIMATED PROFIT @ COMPLETION	JOB TO DATE TAXABLE PROFIT USING 40% PCM			
					ALLOCABLE COSTS													
				DIRECT COSTS	ALLOCABLE COSTS 1986	ALLOCABLE COSTS 1987	SUBTOTAL ALLOCABLE COSTS		TOTAL COST	DIRECT COST	ALLOCATED COST	TOTAL COST			REVENUE	DIRECT COST	ALLOCATED COST	PROFIT
AS PROJECTED AT 12/31/86	6222		200	100	2	N/A	2		102	175	4	179	57.1	22	46	40	1	5
"	6700		100	80	3	N/A	3		83	90	3	93	88.9	7	36	32	1	2
"	6809		300	70	8	N/A	8		78	225	26	251	31.1	49	37	28	3	6
"	6969		650	80	5	N/A	5		85	600	30	630	13.3	13	35	32	2	1
"	6970		700	100	5	N/A	5		105	600	30	630	16.7	70	47	40	2	5
		TOTAL	1,950	430	23	0	23		453	1,690	100	1,790		160	200	172	9	19
BALANCE SHOULD HAVE BEEN AT 12/31/86	6222		220	100	2	N/A	2		102	160	28	188	54.3	32	48	40	1	7
"	6700		130	80	3	N/A	3		83	80	17	97	85.6	33	44	32	1	11
"	6809		367	70	8	N/A	8		78	153	41	194	40.2	173	59	28	3	28
"	6969		703	80	5	N/A	5		85	449	115	564	15.1	139	42	32	2	8
"	6970		1,180	100	5	N/A	5		105	650	141	799	13.1	381	62	40	2	20
		TOTAL	2,600	430	23	0	23		453	1,500	342	1,842		758	256	172	9	74
DIFFERENCE	6222		20	N/A	N/A	N/A	N/A		N/A	(15)	25	10	(2.89)	11	2	0	0	2
"	6700		30	N/A	N/A	N/A	N/A		N/A	(10)	14	4	(3.32)	26	9	0	0	9
"	6809		67	N/A	N/A	N/A	N/A		N/A	(72)	15	(57)	9.10	124	22	0	0	22
"	6969		53	N/A	N/A	N/A	N/A		N/A	(151)	78	(74)	1.74	127	8	0	0	8
"	6970		480	N/A	N/A	N/A	N/A		N/A	50	111	169	(3.53)	311	15	0	0	15
		TOTAL	650	0	0	0	0		0	(190)	242	52		598	56	0	0	56

TESTIMONY OF MR. ANTHONY GRAZIANO
SENIOR VICE PRESIDENT
OF
TRIANGLE INDUSTRIES, INC.
ON BEHALF OF
THE ALLIANCE FOR CAPITAL ACCESS,
THE U.S. CHAMBER OF COMMERCE
AND
THE DIVIDENDS RECEIVED DEDUCTION COALITION

Mr. Chairman and Members of the Committee, my name is Anthony Graziano. I am Senior Vice President of Triangle Industries, Inc. I appreciate the opportunity to appear today on behalf of Triangle; the Alliance for Capital Access, a trade association representing the corporate finance concerns of more than 100 non-investment grade companies that together employ over 450,000 American workers; the U.S. Chamber of Commerce, a federation of over 180,000 businesses, associations and state and local chambers of commerce; and the Dividends Received Deduction Coalition, an informal association of groups representing companies that have issued preferred and common stock or have invested in the stock of other corporations. Included in the coalition are associations and companies representing utilities, thrifts, banks, manufacturers and venture capital companies.

Let me say at the outset that all of us have appreciated this Committee's historic concern with maintaining American companies' access to affordable capital from a variety of sources. Indeed, this sensitivity was most recently demonstrated last year when the Committee took the lead in opposing House proposals that would have raised financing costs for American business.

All of us in the coalition are united by our deep concern about the impact of the proposed reduction in the dividends received deduction (DRD) on the ability of American companies to raise affordable growth capital. There is a tendency to regard the DRD as an arcane issue to be resolved by tax technicians and academics. There is also a misguided notion that the DRD is a corporate tax preference. But the DRD is not a tax gimmick. It prevents the triple taxation of corporate earnings and, therefore, encourages corporations to invest in the common and preferred stock of other companies. And these investments, in turn, provide a considerable amount of the capital required by companies seeking to grow.

Triangle Industries is an example of the kind of company that directly and indirectly benefits from the DRD. Triangle, through our flagship subsidiary, American National Can, is the largest packaging company in the world. We are also the lowest cost producer in most of the markets in which we compete, both domestically and internationally. We are very proud of our low-cost producer status. It is the primary way for American companies to compete in global markets. But it requires the constant investment of capital in the business.

In 1983, Triangle had $260 million in revenues and was losing money. Our stock sold for $13 a share. Today, Triangle has more than $4 billion in revenue, we employ over 23,000 American workers, and we are profitable. And that $13 share of stock was valued at $135, adjusted for stock splits, just last week. And let me hasten to add that we are a taxpayer: in 1987, Triangle's effective tax rate exceeded the statutory rate.

Triangle builds businesses. We have grown, and we hope to continue to grow, in part through acquisitions. But we do not believe in stripping the assets of the companies that we acquire. We infuse our companies with new capital, new ideas, and entrepreneurial vitality. In the past three years alone, we have made almost half a billion dollars in capital investments, more than double the investment of any of our competitors. This year, Triangle was ranked 98th on the Fortune 100. Triangle is one of only 57 companies on the Fortune 100 that had net employment growth in the last 10 years.

I give you this background to set the stage for a fundamental point. Like many businesses, we have needed a wide range of financial tools to create this record of growth.

We have used everything from high yield bonds and common stock to various kinds of preferred stock and bank debt. Removal of any of these various sources of capital would have made it more costly, and far more difficult, for us to expand our business and enhance our competitiveness.

Since 1986, Congress has sharply reduced the DRD from 85 percent to 70 percent for companies that own less than 20 percent of the stock of other companies. Few of us protested this reduction because industrial companies recognized that tax reform would require some base broadening and sacrifice by all. In that context, a reduction in the DRD, while damaging, was manageable. And, frankly, other proposals made in 1987 such as limiting the deductibility of interest on some corporate debt would have been even more damaging.

But the proposed cut to 50 percent would mean that the DRD would fall nearly 40 percent in just two years. The cumulative effect of such a reduction would be to sharply increase the cost of raising capital for industrial, utility and financial corporations in every segment of the American economy. This increase would come at a time when Congress should be doing all it can to lower the cost of capital to American business.

This is a critical capital formation issue. Contrary to popular perception, corporations are significant purchasers of the stock of other corporations, and this proposal would severely discourage that investment. In fact, in the $43 billion public preferred stock market alone, nearly 80 percent of the purchasers are companies eligible for the DRD.

We understand that the Joint Committee on Taxation staff has suggested that ownership of less than 20 percent of another company is somehow less virtuous than owning more than 20 percent. In fact, there are many sound, non-tax reasons for companies to invest less than 20 percent in another company. For example, a high technology firm may invest in another high tech firm to facilitate technology transfers; a group of companies may want to spread some of the risk of a new joint venture; or an oil pipeline may want to spread ownership to avoid antitrust violations.

In fact, one of the best reasons for one company to invest in the preferred stock of another is the efficient use of capital. Right now, my own company has more capital than it will spend this year in its aggressive capital expenditure program. This is because we have already accumulated the cash that we will need to fund next year's very substantial capital program. Both for the good of our own shareholders and for the good of the economic system, this capital should not remain idle until it is ready to be used in our business. One way for us to transfer this capital to another company that needs it today is through an investment in that other company's preferred stock. The efficient utilization of capital by companies that need it today, without the imposition of a third tax, is important to capital formation and therefore job creation in the United States.

The fact is that there is nothing magical about 20 percent; and there is certainly nothing negative about so-called portfolio investment. Investment by companies in one another has a positive economic impact whether at the one percent level or the 40 percent level.

It is worth noting that among the most significant issuers of preferred stock are utilities. Indeed, they comprise about one-half of the public preferred market. To the extent that their cost of capital is increased -- which this proposal would clearly do -- utility rates will also increase.

Furthermore, it has been a long-standing principle of federal tax law dating back to 1909 that corporate profits should only be taxed twice -- once when they are earned by the corporation and once when they are received by an individual shareholder. Each reduction of the DRD, however, increases the triple taxation of corporate profits. First, when earned as income by the corporation in the course of its normal business operations; second, when included as taxable income by the corporate investor; and third, when paid out as dividends to individual shareholders in the investing corporation. This principle has already been severely eroded in the last two years. Further reductions in the DRD would emasculate this principle.

I believe this tax policy is still as sound as it was in 1909. And for those of us involved in the DRD coalition who do not operate in the world of tax theory, it is even more valid than ever before. We live day in and day out with the problem of how to finance growing businesses. In this world, there are two salient points to keep in mind: first, for companies like Triangle to remain competitive and to grow we need access to capital; second, to assure ourselves access to this needed capital we must offer potential investors a competitive after-tax return. That is how we attract their money. It naturally follows that if the DRD is reduced, the investors' tax liability rises. In order to continue to attract investment by other businesses to help finance growth, Triangle and other companies like us will have to pay a higher yield to provide these corporate investors with the same after-tax return.

For example, a 10 percent dividend on preferred stock provides a corporate investor with an after-tax yield of 8.98 percent. If the DRD is eliminated, it would cost the preferred issuer a whopping 4 1/2 percentage points more (a 14.5 percent dividend) to provide the same 8.98 percent after-tax return. Imagine the same rate spike on your home mortgage, and you have some sense of the impact that this would have on the ability of American firms to raise affordable capital to compete in international markets.

Continuing with this example, one less costly alternative to issuing the preferred stock would be to issue debt -- if the company is able to do so. In fact, this would cost the issuer less because the interest it pays is fully deductible, whereas none of its dividends are deductible. This, in turn, will increase corporate debt-to-equity ratios, lower credit ratings and make these companies more vulnerable to restructurings and layoffs in the event of a recession. While prudent reliance on debt financing is desirable, it is also clear that not all companies can or should issue additional debt. Inevitably, some companies that should not do so will turn to the debt markets to fill their financing needs.

More broadly, discouraging the issuance of preferred stock is unsound from a corporate finance perspective. Preferred stock is a necessary part of many companies' capital structures. It is in a company's interest to issue financial instruments with different characteristics. In this way, it spreads its own risk and is able to attract a broad range of investors by varying the risks inherent in investing in the company. Companies can issue only so much straight debt and common stock.

Beyond the general need to issue a range of different capital instruments, preferred stock serves other purposes. For example, a company seeking to reduce its debt-to-equity ratio and improve its credit rating, might issue preferred stock. In other cases, preferred stock is a way for companies to finance a critical part of friendly, productive acquisitions without relying on too much debt.

Further, there is a new breed of companies on the move today characterized by owner management. In these firms, managers own a significant share of the company's common stock, giving them great incentive to perform. Indeed, Fortune Magazine recently found that the one common thread among the 25 companies most likely to join the Fortune 500 next year is a substantial degree of management ownership. Preferred stock is one way that these companies can raise growth capital while maintaining healthy balance sheets. They can avoid too much debt, without yielding ownership to outsiders.

Generally, small- and medium-sized companies have a more difficult time in raising capital than larger firms. It would be extremely unwise to further constrain them by lowering the DRD and making it more costly for them to grow. Large companies may be able to adjust, although that is arguable in many cases. But it is indisputable that the proposal would have a disproportionately negative effect on growing companies, the very firms that have created most of the new jobs in America in recent years. Many of these small- and medium-sized companies, including members of the Alliance and the Chamber, do not have investment grade ratings. We must have available to us the full range of financing instruments if we are to expand. Seriously discouraging the major investors in the crucial layer of preferred equity now available to us and actively discouraging corporate investment in our common stock, as this proposal would, will inevitably damage our ability to grow.

Finally, the proposed cut in the DRD will cause an across-the-board reduction in the value of preferred stock portfolios, as well as those common stock holdings that are generally bought for their yield, such as utility portfolios. Such a reduction is both unfair and potentially dangerous to the stability of the financial markets.

We urge the Committee to drop the proposed reduction in the DRD from the revenue raising options.

TESTIMONY OF RICHARD HAUSLEIN
COMMITTEE ON FINANCE
UNITED STATES SENATE
WEDNESDAY, JULY 13, 1988

INTRODUCTION

My name is Richard Hauslein, Vice President for Human Resources, Dresser Industries. I am appearing before you today at the request of the Section 89 Coalition and The ERISA Industry Committee. My testimony will outline from a Dresser perspective important issues concerning the Section 89 nondiscrimination rules that were added to the Internal Revenue Code by the Tax Reform Act of 1986.

The Section 89 Coalition is a voluntary coalition of both small and large employers, labor unions, managed health care plans, health insurers, and benefits consultants who have banded together to communicate their concerns about Section 89 to Congress. My company is a participant in the Section 89 Coalition and supports its activities.

Let me make it clear that we endorse the concept of nondiscrimination rules for welfare plans. Nondiscrimination rules should ensure both that health and other tax-favored benefits are widely distributed and that the high paid do not receive a disproportionate share of those benefits.

Unfortunately, Section 89 as it currently stands does more to test an employer's ability to gather data than it does to ensure an equitable distribution of benefits. And it positively discourages the expansion of health coverage.

The Section 89 rules assume that an employer is providing discriminatory benefits unless the employer establishes evidence to the contrary. The burden of proof, therefore, is upon the same employer that is also voluntarily providing health coverage to its employees.

IMPACT OF SECTION 89 ON PLAN SPONSORS

To prove nondiscrimination under Section 89, an employer must first identify every coverage option that is offered to any employee. Thus, every single and family coverage, each high and low option, and each separate HMO, PPO or other managed care system, must be catalogued. In the case of Dresser and its wholly owned subsidiaries, this means that approximately 125 welfare benefit plans mushroom into something over 400 plans for Section 89 purposes. Other large companies face an even more formidable task.

Next we must determine which employees are to be included in the test. This requires keeping track of the hours worked by part-time employees and gathering individual sworn statements from employees who are covered by a spouse's plan in another company. Even though payroll systems are often decentralized throughout a company, we must determine on a controlled group basis which individual employees are to be classified as highly compensated. We must also determine which individual employees are eligible for and which are covered by each of the employer's health coverage options.

Under the current rules, all this data must be obtained for every day of the year.

Let me tell you, no company, Dresser included, has this data at hand. A company like mine will have to go out into the field and collect it piece by piece. Data for collectively bargained employees who are covered under a multiemployer plan may not be available to the employer. Employers do not presently have a system for collecting data on the coverage that dependents have from other employers; systems will have to be developed. Even data that is available is often decentralized and on computers that may or may not be compatible with each other. Some companies will have an easier time gathering the necessary data than others. Others, whose plans are just as good, will never be able to collect and analyze all the information necessary to test their plans.

But we are not through yet.

Now we must take the data we have collected and test each separate option. We must determine which plans will be tested as part of a separate line of business and which options in each business can be combined under strict comparability rules. Then we must apply numerical tests to that data. Companies which have few, if any, options in their plans may be able to apply one 80% coverage test. But most companies, Dresser included, will have to apply at least three separate numerical tests to their data (the 50% eligibility test or the alternative eligibility test, the 90%/50% availability test, and the 75% benefits test).

Where the option, or combined options, being tested do not pass all the applicable numerical tests, the value of any excess benefits must be calculated and income must then be imputed to all highly compensated individuals that receive those benefits. Those calculations must be completed in time for the affected employees to fill our their April 15 tax forms.

It is not likely that Dresser or any other major company will drop their health coverage because of these rules. Most major companies think they run nondiscriminatory plans and will make every effort to pass whatever rules are laid out. The issue is not just the high cost of compliance. In many cases employers with good health plans simply will not be able to tell whether they pass these rules.

HOUSE WAYS AND MEANS COMMITTEE PROPOSALS

The changes approved by the House Ways and Means Committee would make some modest progress in simplifying these rules. For example, they open the door toward once-a-year testing; they would allow the use of sampling; they would allow more plans to be grouped together; and they would exclude from testing employees that long ago separated from service.

However, under the Ways and Means proposals, once a year testing may prove illusory if elections and changes in benefits still have to be tracked throughout the year. An employer must still gather some data on all employees before sampling can be conducted, and must still gather sworn statements where employees are covered under a spouse's plan. All highly compensated employees must still be found and tracked. Each separate option must still be identified and valued before it can be grouped with other options. HMOs, PPOs, and similar programs will still present additional problems of identification and valuation and will still be difficult to combine with other programs for testing. Employers must still operate with no significant guidance concerning separate lines of business or what will eventually be acceptable valuation standards. Applying the rules to I.R.C. Section 79 group term life insurance plans remains an impossible difficulty.

The Ways and Means proposals attack some of the symptoms but fail to go to the heart of the problem. We need safe harbors that will permit health plans to pass nondiscrimination rules without resort to elaborate, costly and burdensome testing. Mr. Chairman, the government ought to be able to provide rules that allow a plan designed so that its operation, on its face, will be nondiscriminatory to pass muster without further testing. An employer should not have to go out and collect reams of data every year to prove its plans are nondiscriminatory.

GENERAL IMPACT OF SECTION 89

There is one easy way to pass these tests: Do not offer any family coverage, do not offer any options in coverage, do not encourage employees to join HMOs, PPOs, or any other managed care system, and provide only the most basic (though not necessarily the least expensive) form of coverage. We hope that such drastic steps will not have to be taken.

By requiring each option to be tested separately, the rules discourage the use of alternative delivery systems. Employers fearing failure of any one plan will limit the diversification of options and use of new types of services. Hence, the rules have a negative effect on the momentum behind increased use of HMOs, PPOs, triple option plans and the like.

Dresser feels that Section 89, in its current form, will have a severe restrictive effect on its ability to develop alternative delivery systems at a time when innovative approaches are needed to contain rising health care costs.

By making extensive data collection necessary for family coverage and other similar options, the rules stand in the way of expanding coverage. A small employer is encouraged either not to offer coverage or to offer limited coverage only to its employees.

The rules effectively prohibit pilot and experimental expansions of benefits such as long term care benefits or new managed care systems. Such a plan could easily fail the Section 89 tests, even though the benefits would be offered to employees at all wage levels in the subgroup targeted for the pilot program. Thus the tests inhibit prudent benefit and financing decisions.

The Ways and Means proposals do not solve these basic problems.

CONCLUSION

I am told that the Section 89 rules carry with them a significant revenue figure -- i.e., that the government intends to collect a substantial amount of money by imputing income to individuals who participate in plans that cannot pass these rules. I think that employers will want to pass these rules. Thus I challenge these numbers. I don't challenge their accuracy but their wisdom, because to some extent a high revenue figure is the U.S. government saying that we will write rules you cannot comply with and charge you for it. Mr. Chairman, this just doesn't make any sense to me.

Furthermore, in an area as critical as this, it is mandatory that, whatever the final rules are, employers be given sufficient lead time to comply so that the vital health coverage of millions of employees and their families is not disrupted.

Both we and the government have learned a lot over the last year and a half as we have wrestled with trying to come to grips with these rules. I think that good rules can be written that will achieve the objectives of the law -- including the objectives of not overburdening employers who are covering their employees and of furthering good health policy initiatives across the land.

Nondiscrimination is important because the benefits involved are basic to the well being of millions of workers and their families. According to the Congressional Research Service, 136.5 million non-elderly Americans now receive health coverage through voluntary employer-provided plans that would be subject to the Section 89 nondiscrimination rules. More Americans are covered under employer-sponsored medical plans for retirees. Similar figures apply to employer-provided life insurance plans. Thus, it is clear that prior law has already done much to ensure widespread distribution of benefits.

At the same time, much needs to be done. This Committee and many of its members have expressed concerns about the 30-37 million Americans who do not have health coverage from any source -- two thirds of them workers or dependents of workers. Clearly, whatever is done under the law to ensure nondiscrimination should act as an incentive, not a disincentive, for additional employers to provide coverage for their workers and workers' dependents.

Mr. Chairman, we thank you for your continuing leadership for over a decade in developing national employee benefits policy. We appreciate your interest in working toward a solution to the problems with Section 89.

We also thank Senator David Pryor for his assistance in bringing the issue before the Committee today, Senator John Chafee for his expressions of support and leadership, and the ten members of this Committee who joined with Senator David

Durenburger in a June 17, 1988, letter to Treasury Secretary Baker regarding the absence of regulatory guidance for these new, complicated rules.

I understand that the Section 89 Coalition has been working with the Members and staffs of the tax committees to simplify the rules and develop broad safe harbors that would reduce, or even eliminate, the incredible data collection burdens of the current rules. We applaud that effort. However, time is very short. The Section 89 rules are effective beginning January 1, 1989. Failure of this Committee to find a way to implement welfare benefit nondiscrimination rules on a phased in and gradual basis will cause chaos in an area vital to the health and well being of employees and their families.

Mr. Chairman, we need your help, and we ask for your help.

STATEMENT OF MALCOLM A. MOORE ON BEHALF
OF THE AMERICAN COLLEGE OF PROBATE COUNSEL
AT A HEARING ON THE TECHNICAL CORRECTIONS ACT OF 1988
BEFORE THE FINANCE COMMITTEE
U.S. SENATE

July 13, 1988

Malcolm A. Moore, President of the American College of Probate Counsel (the "College") , has prepared this statement with help from E. James Gamble, Esq. of Detroit, Michigan, Chairman of the College's I.R.C. Section 2036(c) Task Force, and Dave L. Cornfeld, Esq., of St. Louis, Missouri, Chairman of the College's Estate and Gift Tax Committee. The positions and views presented here have not been specifically approved in advance either by the Board of Regents of the College or its Executive Committee. However, the College's president believes that the positions set forth in this document in fact represent the position of the great majority of members of the College, and, as will be pointed out in oral testimony, also represents the views of virtually every estate planning lawyer with whom the witness has spoken over the last several months.

The College is grateful for being given the opportunity to appear before this distinguished Committee to express the views of our membership (which is composed of more than 2600 lawyers who specialize in the practice of trusts and estate law and related tax matters) concerning Section 2036(c) and the proposed technical corrections thereto currently being considered by the Ways and Means Committee of the House of Representatives and by the Senate Finance Committee. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the date it was first organized over 39 years ago. We welcome and accept once again the challenge of working with the Congress to find additional ways for improving and simplifying the nation's transfer tax laws.

1. Section 2036(c) as Enacted.

Section 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987, P.L. 100-203, signed into law by the President on December 22, 1987. The provisions of that Act which constitute new Section 2036(c) were never contained in any bill considered by the Senate; rather they were an outgrowth of some provisions contained in legislation adopted by the House. A House-Senate conference committee adopted, with some modifications, these "estate freeze" provisions contained in the House legislation. Until today there have never been hearings on this statutory provision, nor on any of the proposed technical corrections thereto. The College is gratified that the Finance Committee has afforded this opportunity to interested parties to give their views, for the first time, on Section 2036(c) and the proposed technical corrections thereto. The College (as well as other interested professional associations) has spent a great deal of time analyzing and evaluating this legislation since its enactment.

Section 2036(c) was enacted because of a perception that abuses were taking place in certain so-called "estate freeze" transactions through the avoidance of payment of an adequate transfer tax in connection with the passage of property between family members (typically from an older generation to a younger generation) by an undervaluation of the property being transferred, coupled with the retention of income and control rights in the property.

However, since the passage of Section 2036(c) it has become abundantly clear that the statute as enacted is incapable of being understood and enforced either by attorneys representing their clients or by the Internal Revenue Service, and as a result is not an adequate or appropriate response to the perceived abuses. However, even if the statute had been properly drafted and the ambiguities corrected (if possible) its effect has been, and will continue to be, to virtually paralyze the legitimate transfer of property, by gift or sale, between family members; the majority of these transactions are completely unrelated to "valuation freezing", yet are presently within the legislation's reach. In all parts of the country attorneys and their clients have been placed in a continuing "limbo" not knowing whether the most simple and legitimate of transactions between family members will pass muster under Section 2036(c). This has had the result of placing owners of closely-held businesses, farms and ranches at a distinct disadvantage compared to taxpayers who own readily marketable assets.

The tax law should not create a disincentive to the continuance of family-owned businesses and the passing on of such businesses from older to younger generations of the family. Under Section 2036(c), even after the proposed amendments, the owner of a closely-held business, if faced with the choice of selling to a stranger or to his children on the same terms, would be compelled to choose the sale to a stranger. Further, an owner can not offer a related employee of his business an equity interest as an incentive although he can to an unrelated employee. In addition, Section 2036(c) does not take into account that much, if not all, of the future appreciation may be the result of the efforts of the younger generation shareholders.

The elimination of the exception for a "bona fide sale for an adequate and full consideration in money or money's worth" is patently unfair and results in double taxation. The fair market value of any property takes into account its potential appreciation including the effect of any leverage. Thus, the seller will have received additional money or money's worth which (together with income and appreciation thereof) will be included in his gross estate at death. To then include the appreciation on the transferred interest as well as "in effect" double taxation. Further unfairness results to the purchaser if the purchaser is required to pay the seller's transfer tax (gift or estate tax) with respect to property for which the purchaser has already paid full value. The burden of such potential future transfer tax has the effect of making the property worth less to family members than an outsider, a result which Congress could not have intended.

Given the well-founded criticism aimed at the statute since its enactment, the House Ways and Means Committee recently announced that "technical corrections" will be prepared to provide, among other things, some so-called "safe harbors" for transactions to be excluded from the application of Section 2036(c). It is that effort to which the next section of this paper is addressed.

THE TECHNICAL CORRECTIONS PROPOSED BY THE WAYS AND MEANS COMMITTEE

All the public has seen thus far is the text of an announcement made on June 21, 1988 (JCX-11-88) as to possible "technical" changes which the Ways and Means Committee has proposed to make to Section 2036(c). The practicing bar had thought that the primary thrust of these suggested technical corrections would be to (1) clarify the admittedly vague meaning of a number of words contained in the statute such as "enterprise," "in effect transfers," "potential appreciation," "share in the income of . . . enterprise," "other rights," etc. and (2) state what kinds of transactions would not be affected by Section 2036(c). While the June 21 announcement states that the meaning of some of the statute's vague terms will be clarified, not one of the admittedly ambiguous terms just mentioned is apparently dealt with by the proposed House legislation. Further, the so-called "safe harbor transactions" which are delineated are too few and much too restrictive to be of any real help - in fact they create additional traps for the unwary.

The June 21 proposal would expand the reach of Section 2036(c) well beyond any application to which it would reasonably be said to have been initially intended and delegate some of the fundamental aspects of the statutory provision to regulations. In addition, the proposal would add certain safe harbors as to the applicability of the statute that are so narrow that they broaden the reach of the statute by implying the words of the statute are to be interpreted considerably more broadly than common sense would dictate.

Since the origin of Section 2036(c) was a concern by staff members and others that certain freeze transactions were being abused, given the almost universal belief that the terms of the statute were not only vague but almost all-inclusive in terms of its possible application, the proper way to limit the statute's applicability would be to state what transactions are covered, not what transactions are not covered. This the Ways and Means Committee has chosen not to do. It has rather provided a small (but wholly incomplete) list of transactions which, so long as they comply with a number of specific and restrictive conditions, will not fall within the ambit of Section 2036(c).

The first exception indicated is for a so-called "true loan" situation where an older generation member, for example, loans money to a younger generation member's business enterprise. No Section 2036(c) transfer will be deemed to have occurred if the debt lacks "equity features" and meets "specified requirements regarding term, interest rate, payment dates, voting rights and conversion." The reliance upon a "debt" vs. "equity" characterization is unfortunate to say the least; for eighteen years the Internal Revenue Service has been unable to come up with a satisfactory definition of these terms pursuant to its regulatory authority under I.R.C. Section 385 which deals with the very same distinction. What is the basis for assuming the job will be any easier under these proposed technical corrections?

An example of which could result under this approach is that if a parent loans money to a child's business (or sells the business to a child for an installment note) and one aspect of the debt (or note) does not comport to whatever statutory requirements there are, the act of making the loan (or sale) will be caught in the Section 2036(c) web and resulting transfer taxes on at least a portion of the enterprise's appreciation will be imposed upon the lendor's (or seller's) death.

Indeed the tax could be imposed sooner on the appreciated value of the enterprise to which a loan is made if the loan is paid off prematurely, for example, and is regarded as a "termination" or a "lapse" which is another provision the Ways and Means Committee intends to have inserted in the legislation. Given the fact that a normal good faith loan made by a parent to a child's business (or a fairly constructed sale of the business to the child) should never have been subject to Section 2036(c) in the first place, the niggardly restrictions are all the more offensive.

Another so-called "safe harbor" relates to a sale, lease or compensation agreement. The June 21 announcement notes these will only be saved if there is a "arm's length" agreement which does "not otherwise give that person [the transferor] an interest in the enterprise." As with the loan, apparently the lines will be so strictly drawn (based on admittedly vague language the meaning of which has been extensively litigated, e.g., "arm's length") that it will be easy to have such a transaction fall out of the protection of this safe harbor, which again should not have been included in the statute's ambit in the first place.

The third announced exception relates to so-called "options." Presumably buy-sell agreements will also be included within this category. However, these will only be excepted from the statute's application if the exercise of the option or the operation of the buy-sell agreement produces a value of the property involved equal to its fair market value at the time the option is exercised or the property is sold. Virtually no buy-sell agreement will be protected by the provisions of this "safe harbor" because the ultimate sale price is usually determined by a predetermined formula, which provides some certainty to the parties to the agreement.

Existing law provides that if such buy-sell agreements are not fair at inception, or are substitutes for testamentary dispositions, they cannot effectively fix, for transfer tax purposes, the price of the asset being sold. The only kinds of buy-sell agreements which this proposed safe harbor would apparently protect are those which simply provide for restrictions on the transferability of the assets, not ones that attempt to strike a fair value for the future purchase of assets so that a potential purchaser (usually a younger generation member) will know what he is getting into in terms of committing himself to make such a purchase. Apparently even a preexisting buy-sell agreement entered into in good faith by nonrelated parties would be caught by the statute if a family member (e.g., a child of one of the original entrepreneurs) became a party to the buy-sell agreement.

Those are the only specific exceptions which apparently will be allowed. None of these delineated transactions are ones which should ever have been included in the swath of Section 2036(c) in the first place. Rather than helping, the proposed amendment simply makes the whole situation worse by being overly restrictive in terms of what transfers are to be excluded, and then by making the tests which must be met to have such transactions excluded so rigid and extensive that a number of these transactions will nonetheless fall prey to the statute's operation.

Numerous questions will still abound in terms of what the statute is intended to cover. For example, is life insurance an enterprise so that irrevocable life insurance trusts which contain benefits for the insured's spouse but whose eventual beneficiaries are the insured's children will be included in the insured's estate by reason of the application of Section 2036(c)? Practitioners should have been assured that the statute was not intended to apply to the gift of a minority stock interest by a parent to a child in a corporation that only has one class of stock outstanding. In the same category should be the creation of a family partnership followed by a gift of some limited partnership interests to children. These are only three examples of transactions which should clearly be outside the purview of the statute but for which no safe harbor has been delineated.

The omission of satisfactory definitions for a great number of crucial terms in the statute and the unrealistically narrow provision for so-called "safe harbors" are not the only reasons that the House proposed technical corrections make Section 2036(c) worse, rather than better. For example, the announced intention to treat "terminations, lapses, and other changes in interests in the enterprise" as a deemed gift sweeps many more transactions into the ambit of Section 2036(c) than the present legislation does. This proposed change even goes further than the proposed technical amendment which was announced on March 31, 1988 which would eliminate the ability of a transferor to preclude the application of Section 2036(c) by making a transfer of his retained power or interest so long as it was done within three years of death.

The Ways and Means Committee states that "The estate would be given the right to require that the transferor pay his or her share of estate tax attributable to operation of the freeze provisions." Given the fact that Section 2036(c) indeed necessitates the payment of an estate tax on assets no longer owned or controlled by the transferor, such a provision is necessary. It points up, however, the enormous unfairness of requiring a child who has bought the family business to pay a crippling transfer tax upon a parent's death, or even earlier if the March 31, 1988 provisions of the Technical Correction Act is adopted which treats a disposition of the business by the child as a "transfer" which triggers a "deemed" estate tax.

Section 2036(c) has been a disaster since its enactment. It has, as pointed out earlier, virtually paralyzed good intentioned and fair transfers of all sorts of business and other assets between family members. No knowledgeable estate or trust practitioner in the country that this witness has spoken with (and he has spoken with a great number) have felt the statute is really salvageable in terms of being able to eliminate the perceived evil for which it was enacted - abusive freeze situations. However, there was some hope that if the admittedly vague terms of the statute were defined in some detail, that if the unwarranted and punitive provision which includes in the statute's ambit sales for full and adequate consideration was removed, and that if a good faith attempt was made to clearly set forth those transactions to which the statute would apply, there would be some light at the end of the tunnel. Instead what the public has been presented with is a "technical corrections" bill which not only fails to clarify ambiguous terms but adds to the statute's complexity and pervasiveness through additional unworkable provisions.

As is noted below, there is a much more appropriate and reasoned approach to deal with whatever estate freeze abuse situations might exist. We applaud the staff of this Committee in its view that improving current valuation techniques and sanctions is a more appropriate way to try and deal with any problem there might be. That approach would have the added benefit (which is really a necessity) of providing certainty and finality to family transactions which, for a great number of reasons, cannot afford to remain open-ended as is the result under current Section 2036(c).

A POSSIBLE APPROACH

The College believes that the elimination of abusive freezes is a desirable objective. Its Section 2036(c) Task Force also believes that a relatively simple solution will be far more effective than a provision like Section 2036(c). We believe that legislation designed to eliminate abuse freezes should encourage prompt disclosure to the Internal Revenue Service of transactions that have a freeze potential and early resolution of any valuation dispute between the taxpayer and the Service. It should also utilize established gift tax concepts and audit procedures.

Persons whose primary asset is an interest in a family-owned business should not be put in a substantially worse planning position than persons whose primary assets are marketable fixed income investments and growth stocks. A person with a diversified portfolio can give away the growth stocks and keep the fixes income securities, pay the gift tax and not be faced with the possibility that post-gift appreciation will be included in his estate. The owner of a small business should not be forced to sell his business to accomplish the same result, but Section 2036(c) forces him either to sell or to abandon the kind of long-range tax planning that the Code makes available to the owner of readily marketable assets.

The primary method available to the owner of a small business corporation to achieve planning parity with the owner of a liquid investment portfolio has been the recapitalization. Many of these recapitalizations have been straightforward transactions in which the newly created interests contain traditional investment features that permit their valuation by standard methods. Gift tax returns have been filed and valuation disputes have been resolved by audit or litigation. When this kind of transaction is disclosed on a gift tax return and the Internal Revenue Service (the

"Service") has an opportunity to scrutinize the transaction, the transfer tax system works just as well as it does with the person who owns the investment portfolio.

There have been cases, however, where taxpayers have attempted to avoid gift tax audits by the Internal Revenue Service by taking extreme positions in designing the stock interests issued in a recapitalization, by claiming an unrealistically low value for the stock that they give away, and by failing to report the transfer on a gift tax return. This is the type of abusive freeze at which Section 2036(c) is aimed.

The Task Force believes that the abusive freeze problem can be solved if Congress adopts legislation that will increase taxpayer compliance with the gift tax reporting requirements and enhance the gift tax audit process. The proposal will accomplish these important policy objections:

- It will raise revenue by encouraging the payment of the proper amount of gift tax on these transactions, thereby producing transfer tax revenues for the government sooner than a solution that relies exclusively on an estate tax provision;

- It will discourage the owners of small businesses from entering into abusive recapitalizations. As a result, it will cause these people either to pay a gift tax on the interests they do transfer or to hold their entire interest until death when the full value of that interests will be included in their estate;

- It will, in effect, make any post-transfer appreciation subject to the estate tax if a gift of an interest with growth potential either is not reported on a gift tax return or if its value is reported but substantially understated; and

- It will achieve these purposes without a complete upheaval in the estate tax rules and the extension of those rules to many transactions that are not used for tax avoidance purposes. It will also eliminate the need to create elaborate "safe harbors" for those transactions.

The proposal is designed to enhance the effectiveness of the gift tax audit procedure by giving taxpayers an incentive to ask for a gift tax audit in order to avoid adverse future transfer taxes. A transaction to which the proposal would apply would be defined to embrace only abusive freeze transactions only and would provide that those transactions would result in an incomplete gift if a taxpayer fails to meet the following gift tax filing and audit criteria:

- If an affected transfer of the property interest with growth potential is reported on a timely filed gift tax return, and if the Service audits the return, the gift would be complete. If there is a taxable gift, any tax due will be paid with the return or as a result of the audit.

- A new Code provision would permit a taxpayer to ask for an early audit of any gift tax return. If the Service fails to begin an audit within 18 months after one is requested, the gift would be complete and there would be no further transfer tax consequences. A possible condition to the request for early audit and determination might be a waiver of the use of the unified credit against any additional tax due to undervaluation on the return so that the Service would have an incentive to audit.

- If a nontaxable gift tax return is filed, but the Service does not audit the return and no request for an early audit is made, an affected transfer of the property interest with growth potential would be incomplete if the gift was undervalued by more than a specified percent, e.g., 25%.

- If the Service audits the return and it believes that events may occur in subsequent years that will have gift tax implications,such as the failure of a preferred stockholder to enforce his right to receive dividends, the taxpayer and the Service can enter into a closing agreement using the procedure provided for in I.R.C. Section 7121 and Rev. Proc. 68-16, 1968-1 C.B. 770. It will be much more effective for a field agent, an appeals officer or government trial counsel to tailor the provisions of a closing agreement to a taxpayer's specific situation than to attempt to deal with diverse and unpredictable fact situations by adding specific provisions to the Internal Revenue Code.

It is submitted that this proposal provides an inducement for the taxpayer to take the initiative in reporting the gift of a growth interest and to value it with a reasonable degree of objectivity; it also provides an incentive for the taxpayer to invite an audit of his return in order to avoid an open statute of limitations for gift tax purposes. The government will realize additional revenue earlier than under an estate tax measure; and it will be protected from the taxpayer whose objective is to disclose virtually nothing on a gift tax return in the hope that he eventually can establish that what he did disclose was sufficient to cause the gift tax statute of limitations to run.

We realize that as this proposal is examined in more detail, issues will arise that must be resolved. The College and its Task Force stands ready, willing and able to make suggestions and to offer assistance that will make the gift tax audit procedures effective to accomplish the objectives of eliminating the abusive estate tax freeze and enhancing the collection of additional gift tax revenue.

I appreciate the opportunity afforded the American College of Probate Counsel and me as its President the opportunity to testify today.

Miscellaneous Tax Requests of Senator Frank H. Murkowski for the July 12, 1988 Senate Finance Committee Hearing on the "Technical Corrections" Act of 1988.

Members of the Finance Committee:

I'd like to bring to your attention several tax corrections that I believe are needed to address certain problems caused by recent tax Acts. In-depth individual letters on each problem have already been sent to the Committee, and so I use this occasion to briefly highlight and underscore my concerns.

Alaskan children.

The Tax Act of '86 severely restricted the ability of tax dependents, especially children, to offset tax on unearned income, making it more difficult for families and children to save. This was done primarily to discourage parents from shifting tax liability on unearned income to children. Unfortunately, in trying to solve this problem, the Act went too far by penalyzing unearned income of tax dependents from whatever source, whether from income shifting or not.

Alaska children have been particularly hurt by this as they receive a yearly Alaska Permanent Fund Dividend, a direct state benefit, that is considered unearned income. Last year approximately 1/3 of our state's population found itself on the tax rolls for the first time. Almost all were of low-income children.

The Dividend in 1988 is estimated to be at roughly $800. Under the Act, tax dependents must file a return and pay a tax on unearned income above $500. Before the Act, Alaskan tax dependents were able to use a personal exemption and a standard deduction to offset tax on the Dividend. But no longer. The Act ended the personal exemption and reduced the standard deduction for tax dependents. Because of this, all Alaska tax dependents that receive a Dividend will have to file and pay a minimum $45 tax.

A correction to the Tax Act of '86 is needed to prevent the triggering of an automatic filing of a return and tax from the receipt of a Dividend by a dependent Alaska child.

I recommend that the minimum standard deduction of Alaska tax dependents be increased to the amount of a Dividend. This would help correct the unintended failure of Congress to recognize the Act's unique adverse effect on tax dependent Alaskan children. It would be consistent with a major purpose of tax reform -- to remove low-income people from the tax rolls. It would be also consistent with precedent when a similar law was passed at my request by Congress in 1982. It would not alter the primary purpose of tax reform -- to prevent parent to child income shifting. The revenue loss would be minimal, roughly $4 million in 1988.

Alaska Native Corporations.

The Deficit Reduction Act of '84 and the Tax Act of '86 made it possible for Alaska Native Corporations created under the Alaska Native Claims Settlement Act of '71 (ANCSA) to affiliate with and sell net operating losses (NOL's) to their profitable (non-Native) subsidiaries until 1991. This was done primarily to make the Corporations whole under ANSCA.

The House Ways and Means Committee is proposing to end those NOL sales after April 26,' 1988 unless the losses were incurred and sold under an agreement entered into before April 27, 1988. The Joint Tax Committee estimates that this would pick up more than $800 million in added revenues.

Several Alaskan Native Corporations have certain NOL transactions pending and may be significantly affected by the effective date of the proposal. Thus far, I have been contacted by the following Alaska Native Corporations -- SeaAlaska, Bering Straits, CookInlet, Goldbelt, Arctic Slope, Tyonek, and Calista. Each finds itself in a different situation. Others may also be affected. More information on this is being gathered and will be provided as soon as available.

A tax correction to grandfather in, or change the proposal's effective date, may be needed to address these problems. Any proposal to end the sale of NOL's should at the very least include a fair and orderly transition.

Remote federal court employees.

From 1943 every federal worker in a remote geographical area received a tax-exempt cost-of-living pay differential. However, due to a recent IRS revenue ruling that went into effect October 13 of last year, federal court workers no longer will receive a tax-exempt differential. This will affect some 366 federal court employees in Alaska, Hawaii, Guam, Puerto Rico, and the Virgin Islands. The ruling overturned forty years of tax precedent, and although technically correct, it is strikingly unfair.

By law, under 26 U.S.C. 912, tax-exempt executive branch federal pay differentials must be approved by the President. As the President only approves executive branch pay differentials, federal court employees do not technically qualify for tax-exempt pay differentials.

A tax correction is needed to restore tax-exempt cost-of-living pay differentials for federal court employees in Alaska, Hawaii, Guam, Puerto Rico, and Virgin Islands. Senator Inouye and I have introduced a bill this Congress on this, S. 1954.

Its cost would be negligible -- roughly $200,000. It would help middle income federal court employees perform needed services in remote areas of our country; end an unfair pay inequity among similarly situated federal employees; and correct a technical legal flaw that is inconsistent with decades of tax policy.

Alaskan Fish export/imports.

Alaska fish exports are barged through the Port of Tacoma in Washington, to the Far East. The exports are taxed twice during a continuous transhipment while in port -- once at unloading from the barge, and again upon reloading onto a larger vessel bound for the Far East. It is estimated that this second tax costs the shippers approximately $20,00 per year.

Oddly enough, had the same fish not been barged and freshly caught or shipped for domestic use, no port-use tax would have been due. That is because of a special rule under the Act which was adopted in recognition of Alaska's unique dependence on waterborne commerce. However, since the fish were exported, they were subject to a double port-use tax -- an inconsistency I find difficult to understand in light of this nation's trade imbalance.

Under the Act, cargo that is shipped through a U.S. port is subject to a port-use tax. For practical purposes this means a double port-use tax for Alaskan shippers who must rely on smaller vessels (barges) to carry their goods to and from larger vessels in large U.S. port centers.

A change in the Harbor Maintenance Revenue Act of '86 is needed to end the double-port-use tax on identical Alaska cargo shipped through a U.S. port. This proposal has been agreed to twice before, once in the Senate's version of the Water Resources Development Act of '86, and again in last year's House Budget Reconciliation bill. It is a modest request -- roughly $20,000 in revenue.

Non-profit organizations.

The Tax Act of '84 permitted non-profit organizations to raise tax-exempt funds from games of chance, retroactive to June 30, 1981.

Later, the Tax Act of '86 made the games of chance revenues taxable, except for those in North Dakota, retroactive to 1981. Because of this, all non-North Dakota non-profits owe back-taxes on tax-exempt games of chance revenues received after June 30, 1981.

This has worked a particular financial hardship on many non-profits, especially those in Alaska. For example, Alaskan non-profits that collected tax-exempt fund raising revenues after 1984 from "pull-tabs", a game of chance run primarily out of bingo halls, now owe substantial sums in back-taxes for taxable years after 1984. For tax year 1986 alone, the Girl Scouts Association of Fairbanks, Alaska owes $20,000; the Retarded Citizens of Alaska, $20,000; and the Alaska Crippled Children's Association, $2,000.

I ask that the Committee correct this problem to prevent the unfair retroactive taxation of games of chance revenues of non-profit organizations. A revenue estimate is being prepared by the Joint Tax Committee.

Diesel fuel tax.

Since April 1, 1988, due to changes in last year's Budget Reconciliation Act, off-road users of diesel fuel have been paying for the first time a 15.1 cents per gallon tax. A refund may later be claimed for that portion of diesel fuel used off-highway.

The new changes have caused tremendous cash flow problems, particularly for the U.S. commercial fishing industry. That is why I testified before a Finance subcommittee hearing to ask for legislation to correct this problem. A copy of my testimony on this is attached for your use.

A tax correction is needed to exempt off-road users from payment of a diesel fuel tax. S.2223, of which I am a co-sponsor, would do this, and I ask that it be approved as quickly as possible. It will go a long way in helping marine users, utilities, farmers, and construction groups.

Frank H. Murkowski

Statement of John O'Brien, President and Chief Executive Officer, Grumman Corporation, on behalf of The Aerospace Industries Association

My name is John O'Brien. I am President and Chief Executive Officer of the Grumman Corporation, a major aerospace company that designs and produces military aircraft, space systems, and commercial aircraft components. I appear today on behalf of the Aerospace Industries Association for which I serve as a member of the Board of Governors.

The aerospace industry includes many of the nation's largest business corporations. It employs 1.3 million people, over 10 percent of all U.S. employees engaged in the manufacturing of durable goods, and contributes significantly to our national defense and standard of living. The aerospace industry continues to produce a solid trade surplus that contributes substantially to offset the adverse impact of American losses in other categories of trade.

The tax liabilities of aerospace companies have been increased by each of the 1982, 1986, and 1987 Acts by the acceleration of tax payments with respect to the performance of long-term contracts. The 1982, 1986, and 1987 Act changes to the method of accounting for long-term contracts alone will increase taxes by over $40 billion from 1982 through 1992. A large portion of this amount will be paid by aerospace companies.

The 1988 Ways and Means Committee technical corrections bill includes further changes in accounting for long-term contracts to raise an additional $2.4 billion from 1988 through 1991. The aerospace industry strongly opposes being singled out to provide additional revenue by a grossly unfair system of taxing long-term contracts. These changes will add to the already serious cash flow problems of the industry by requiring the prepayment of taxes. These cash flow problems will adversely affect the ability of the industry to produce more jobs, to advance technology that will strengthen our national defense and improve our standard of living, and to compete in international markets.

The industry is very concerned about the negative effect that changes in tax and procurement policies are having on its ability to perform. The MAC Group studied these issues for the industry and published a report this past February. By analyzing several existing long-term programs under the new policies, the report concludes that "there would have been no financial reason to bid the programs." Other findings of the report attributable to policy changes are (1) companies will be required to borrow heavily and some will be unable to attract the necessary capital, (2) research and development will decrease, (3) low-technology alternatives will be used more often, (4) productivity will decrease, (5) there will be less competition in the bidding process, and (6) U.S. firms will have more foreign competition. The study shows that a major contributor to the problems of the aerospace industry is the acceleration of taxes paid on long-term contracts brought about in one tax bill after another since 1982.

Starting with the Tax Equity and Fiscal Responsibility Act of 1982, long-term contractors came under attack because of low tax payments in relation to financial statement profits. Substantial changes were made in TEFRA which increased effective tax rates significantly, but because of a three year phase-in of the TEFRA reforms, long-term contractors came under attack again as low payers of tax in 1986. In the 1986 Tax Reform Act, the system of cost-to-cost percentage of completion was imposed on 40 percent of the income from long-term contracts to boost the amount of tax paid by long-term contractors and raise $3.5 billion. In 1987, the percentage was increased to 70 percent to raise an additional $2.2 billion. The provision recently adopted by the Ways and Means Committee is to require all income from long-term contracts to be reported under the cost-to-cost percentage of completion method.

The tax writing committees have been concerned with the public perception that some major corporations pay little tax in relation to their financial income. The aerospace industry is no longer a problem in this regard. A survey of 11 major aerospace companies reflects an average effective tax rate of 38 percent in 1987, and projected effective tax rates of 60 percent in 1988, 41 percent in 1989, and 68 percent in 1990. These rates are far in excess of the top marginal rate of 34 percent and are brought about by both the transitional adjustments attributable to the changes in tax accounting rules and the permanent effect of paying tax on income before it is earned and reported for financial statement purposes. The full results of the survey are reported in an attached table.

The Aerospace Industries Association is not asking for the restoration or partial retention of the completed contract method of accounting (CCM), nor does it seek any form of preferential tax treatment. Instead, we want to focus on the cost-to-cost percentage of completion system being used to replace both CCM and the other methods of accounting historically used by long-term contractors. The cost-to-cost percentage of completion system inappropriately taxes long-term contractors before they earn the income and is inconsistent with the manner in which other taxpayers are taxed.

Under the percentage of completion system (PCM), taxpayers can be taxed on income before they have earned the income. This is a significant departure from our system of taxing income when income is realized and is analogous to taxing an automobile manufacturer on the profit in an automobile as it moves down the assembly line instead of when it is sold. The consequence of this procedure is that the taxpayer is taxed before payments are received and before a transaction has occurred which gives rise to an account receivable that can be borrowed against. This last point, the absence of an account receivable, distinguishes long-term contractors in an important respect from sellers of goods who prior to 1987 used the installment sale provisions. Those taxpayers made sales that gave rise to obligations in an amount that included their profit on the sales. Long-term contractors generally have no right to profit as they incur costs and although they can borrow against their work-in-process or progress payments, they cannot take mere expectations of unrealized profits to the bank to finance tax payments.

Proponents of the percentage of completion system argue that it is used for financial statement purposes and, therefore, must clearly reflect the pattern of income earned. In response, I must tell you that not all companies that are subject to percentage of completion for tax purposes use it for financial statement purposes and that the percentage of completion system used for financial reporting is a very different system than currently is prescribed for tax purposes. No financial accountant would permit the blind adherence to cost-to-cost percentage of completion as it is used for tax purposes. We do not use percentage of completion at Grumman for financial statements because we believe that income is more clearly reflected by reporting it at the time we make shipments under the contract. This is the method of reporting income for financial statements that is used by many large aerospace companies.

The cost-to-cost methodology of percentage of completion presents added problems. That system allocates contract income on the basis of contract costs. The system is based on the erroneous premise that each dollar of contract cost produces the same amount of income. A few simple examples will illustrate the problem with this premise.

Under cost-to-cost percentage of completion, a contractor that expects a 10 percent profit on a contract is deemed to earn a profit equal to 10 percent of the cost of the materials at the time that they are purchased for use in the contract, even before any work is performed on the contract.

A Navy-Grumman contract to build 30 F-14's may take five years. For the first three years, Grumman is incurring costs -- buying and machining material, buying subsystems from subcontractors, and actually spending about 60 percent of the total contract cost. This is before even one plane is completed. Grumman is only entitled to receive 75 to 80 percent of allowable costs from the Navy in the form of progress payments. Full cost recovery and any profit on the contract is received in years four and five of the contract, at the time the planes are delivered, tested and accepted.

PCM requires us to pay a tax on 60 percent of the contract profit before we earn the right to bill the Navy for the profits related to the planes.

Progress payments, by the way, seem to have been misunderstood by some as being part profit -- they are not. Progress payments represent a financing method. The government finances part of the contract inventory, but in lieu of these payments, contractors cannot factor an interest cost into the contract price. The government feels it can finance at a lower cost than a contractor. But progress payments do not represent profit under any definition.

The problem illustrated is that costs do not accurately measure profits. Our tax system normally taxes profits; it should not impute profits on cost for a single class of taxpayers.

The task of apportioning income over a long-term contract is an extremely complex issue. I believe that, with the proper attention to the issue, a system can be developed that will be fair to contractors and protect the revenue. We already have provided a specific proposal to the staff of the Finance Committee. It would gear the reporting of income for tax purposes to the time a contractor has the right to receive payments under the contract, including progress payments. We ask this Committee to consider the serious flaws in cost-to-cost percentage of completion, and to substitute a new system of accounting for long-term contracts that is fair and consistent with the tax accounting system of other U.S. manufacturers.

* * * * * * * * * * *

In summary, the aerospace industry should not be forced to pay more taxes under the cost-to-cost percentage of completion method. This method taxes income before it is earned and before the contractor can collect a profit or borrow against an account receivable to pay the tax. We ask the Committee to work with us to develop a fair system for taxing long-term contractors.

Aerospace Industries Association Survey
Average Effective Tax Rates

1987 - 1992

	Current Law	Full Cost-to-Cost Percentage of Completion
1987	38%	---
1988	60%	61%
1989	41%	43%
1990	68%	76%
1991	40%	46%
1992	37%	39%

Based on historical data and projections from The Boeing Company, Grumman Corporation, General Dynamics Corporation, Hughes Aircraft Co., Lockheed Corporation, Martin Marietta Corp., McDonnell Douglas Corp., Northrop Corporation, Raytheon Co., Rockwell International, and TRW Inc.

SUBMITTED BY SENATOR PRYOR

the Principal Financial Group

Federal Government
Relations Office

Small Employer Survey
Section 89 Nondiscrimination Tests

Summary

The typical small employer (under 10 lives) performing the nondiscrimination tests will begin with the least complex, the 80% participation test. To determine the percentage of small employers who would pass this test, we surveyed a cross-section of our small employer/customer base. Following are the results and analysis of this survey.

Survey

1. A survey of 100 customer/employers was done in April/May 1988
2. The survey targeted employers who employ less than 10 people.
3. All employers of this size
    a. provide only one level of benefits
    b. provide benefits to full-time persons (25 hours or more per week)
    c. provide the same level of contributions to each employee and dependent plan
4. These companies are 24% proprietorships/partnerships, 76% incorporated.
5. The survey collected the information required to perform the 80% participation test.

Results

1. Testing employee plans separately, 56% failed the test.
2. Testing dependent plans separately, 70% failed the test.
3. Using aggregation (our best understanding) of employee and dependent plans, 68% failed the test.
4. State Specific Results

    Employers in certain states comprised the majority of the survey. Following are results for these states separately:

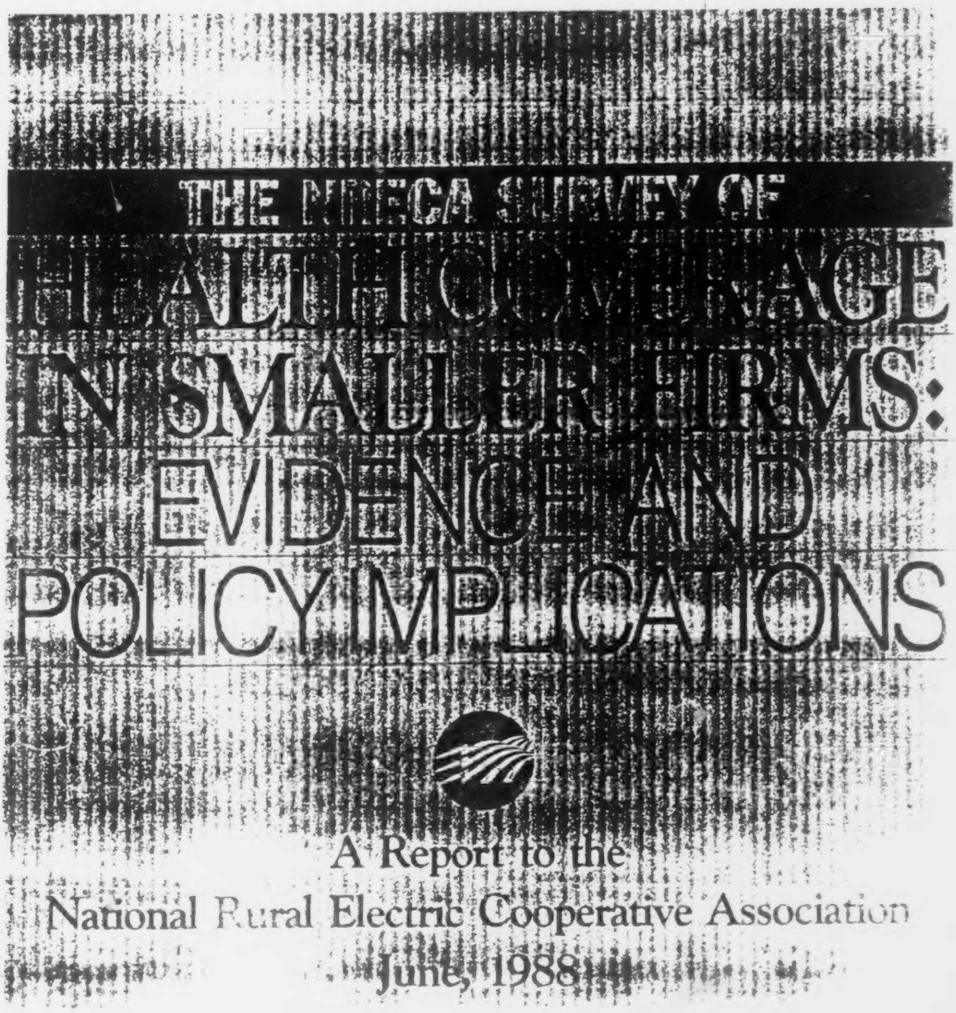
State	Total Surveyed	Employee Plan Failure %	Dependent Plan Failure %	Aggregated Plan Failure %
Arkansas	12	42%	75%	67%
California	28	68%	65%	71%
Texas	25	60%	65%	63%
Washington	11	55%	91%	91%

Analysis of Failure

1. Employee plans failed to meet the 80% participation required to pass this test for the following reasons:
    a. 1% failed - coverage declined due to statement of health
    b. 16% failed - plan too expensive to participate
    c. 46% failed - part-time employees not eligible for the plan
    d. 37% failed - employees covered as dependents under spouse's employer plan; waived own employer's coverage
2. Dependent plans failed to meet the 80% participation required to pass this test for the following reasons:
    a. 33% failed - plan too expensive to participate
    b. 13% failed - dependents of part-time employees not eligible
    c. 54% failed - dependents covered under the spouse's employer plan; waived surveyed employer's coverage
3. Aggregation of employee and dependent plans which fail to meet the 80% participation as follows:
    a. 12% failed due to low employee participation
    b. 25% failed due to low dependent participation
    c. 63% failed due to low participation of both employees and dependents

Principal Mutual Life Insurance Company

SUBMITTED BY SENATOR PRYOR



THE NRECA SURVEY OF
HEALTH COVERAGE
IN SMALLER FIRMS:
EVIDENCE AND
POLICY IMPLICATIONS

A Report to the
National Rural Electric Cooperative Association
June, 1988

Executive Summary

In late 1987, the NRECA commissioned a survey of the health insurance coverage offered by small employers in rural areas. The survey was designed to discover the prevalence of insurance coverage, the type of insurance offered, who pays for coverage, and how employers make plan decisions.

The NRECA survey is the first survey of health insurance coverage among small employers to focus on the rural population. This report concludes that health insurance coverage patterns in rural areas differ significantly from the nation as a whole. Fewer than two-thirds of employees in smaller rural firms are covered by employer-provided health insurance plans, compared with over 80 percent of employees nationwide and 95 percent in medium and large firms.

Covered employees lack several of the safety net features of employer-provided coverage available in larger firms. Retirees are much less likely to be covered, and may be less likely to have dual coverage. Employees are more likely to contribute to the plan's premium costs, and a significant share of employees pay the entire plan cost. In particular, one in five of covered employees in the smallest firms pays the entire cost of the plan.

Lack of health insurance in nonagricultural rural businesses is largely a problem of the smallest and newest firms. In the NRECA sample, firms with fewer than 10 employees accounted for 88 percent of the firms without coverage and 46 percent of the noncovered employees.

Cost is the major barrier employers face in deciding to offer coverage and their dominant consideration in choosing and changing plans. As a firm's economic performance improves, the likelihood that it will offer coverage increases. Thus, the problems facing rural economies are probably retarding voluntary coverage expansion.

Even with the cost-reducing features built into S. 1265, universal coverage will increase costs and administrative burdens for smaller firms. Some of the cost burden could be reduced by extending full deductibility of health insurance premiums to noncorporate as well as corporate entities. This would be fair once all employers are required to offer coverage.

The administrative burden could be reduced be simplifying coverage, reporting, and record-keeping requirements. For smaller firms that only offer one plan, the reporting sanctions of IRC section 89 (k) and certain COBRA coverage continuation provisions could be simplified once universal coverage is in place.

INTRODUCTION

This report examines the results of a recent survey of health coverage among small rural employers conducted by the National Rural Electric Cooperative Association (NRECA). The report uses these results to examine the potential impact of universal health coverage initiatives on smaller employers, and policy concerns affecting smaller employers in the universal coverage debate.

The NRECA Survey

In late 1987, the NRECA commissioned a survey of the health coverage offered by small employers in NRECA service areas.[1] The survey was designed to discover the prevalence of coverage, the type of coverage offered, the distribution of health coverage costs between employers and employees, and how employers make plan decisions. This report concludes that health coverage patterns in small rural firms differ significantly from the nation as a whole.

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[1] Arthur D. Little, Inc., "Report to NRECA Retirement, Safety and Insurance Department, Phase II: Market Research Results," October, 1987 (hereinafter "NRECA Survey"). For detail on the derivation of the data presented in the current report, see Appendix.

The Minimum Health Benefits for All Workers Act

On February 17, 1988, the Senate Committee on Labor and Human Resources passed The Minimum Health Benefits for All Workers Act (S. 1265), which would require all employers to offer a minimum package of health coverage benefits to all adult employees working more than 17.5 hours per week and their dependents (for detail on the benefits required in the bill, see Table 1). Employees would generally be eligible for coverage no later than 30 days after beginning employment.[2]

Employers would be required to pay at least 80 percent of the premium for the minimum benefit plan, rising to 100 percent for workers with incomes under 125 percent of the minimum wage. Employers offering a more generous plan than the minimum specified could require higher deductibles, coinsurance payments, or employee contributions, as long as the employer's contribution was actuarially equivalent to that required under the minimum benefit plan.

The bill contains provisions designed to ease the burden of the requirements on small businesses. Employers with fewer than 10 employees who have been in business less than two years would have to offer employees only a low-cost catastrophic plan to cap out-of-pocket medical costs. Employers with fewer than 5 employees could phase in coverage over five years, but would have to provide catastrophic coverage after three years.

Small employers' costs would also be reduced through the establishment of regional insurance pools. All businesses

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[2] Firms that offered plans with a longer waiting period as of the law's effective date would be grandfathered to allow a waiting period of no longer than 6 months, but would have to offer at least catastrophic coverage after the first month and until the end of the sixth month of employment. The grandfathering period appears to extend until the first day of the second plan year that begins after the date of the Act's enactment.

Table 1.

Provisions of the Minimum Health Benefit Plan
Under S. 1265

Benefits:

- Catastrophic provision limiting out-of-pocket costs to $3000 per year per family.
- No exclusions based on health status or pre-existing conditions.
- Mental-health benefit covering at least 45 days of inpatient care and up to 20 outpatient visits annually. Employees could be required to pay 50 percent of the costs of outpatient care.
- State-mandated benefits would not be included in the minimum package.

Cost Sharing:

- Coverage of 100 percent of costs of prenatal and routine well-baby care. No deductible could be imposed for these benefits.
- Coverage for at least 80 percent of cost of medically necessary hospital and physician care and lab tests (that is, employee coinsurance would be limited to 20 percent).
- Deductibles would generally be limited to no more than $250 per individual and $500 per family.
- Employers would pay at least 80 percent of the premium cost of the minimum benefit plan, and 100 percent of the premium costs for employees with incomes under 125 percent of the minimum wage.

Employee Eligibility:

- Employees generally eligible for coverage no later than 30 days after employment.
- No eligibility or coverage limitations to be imposed on the basis of health status or pre-existing conditions.

Small Firm Relief:

- Small and new firms would be allowed to phase in coverage, offering only catastrophic coverage initially.

without coverage on the law's effective date would be required to buy coverage from the regional insurers. Businesses with fewer than 25 employees would be allowed but not required to buy through the pools if they have coverage on the effective date, but would be required to buy through the program upon changing insurers. Currently, an estimated 25 percent of small employers' premiums covers sales expenses, administrative costs, and profit.[3] The regional insurer structure is expected to reduce this share to 15 percent.

The NRECA survey provides several unique resources for the health coverage debate. It is the first survey of small employers to focus on the rural population. The critical state of many rural economies requires that the needs of rural employers and their employees be explicitly considered in this debate. Despite the survey's rural focus, however, the problems and concerns it identifies are largely common to small firms everywhere.

The survey also provides new information on the decision-making process of small employers. Most available data on health coverage can only examine existing coverage patterns, and cannot tell us anything about how these patterns came to be.

This report begins with a description of the NRECA sample and the population from which it is drawn. The report then covers four topics:

- Who is covered in rural areas;
- Why employers adopt coverage and choose plans;
- Who is not covered and why not; and
- The survey's implications for public policy decisions on health coverage.

THE NRECA SAMPLE

The NRECA sample consists of employers with 60 or fewer employees in seven states (Table 2).[4] The 822 employers in the sample, with an estimated 7930 employees, were drawn from a group of over 94,000 small employers and an estimated 900,000 employees in five industrial categories.

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[3] U.S. Senate Committee on Labor and Human Resources, "Revised Summary of the Minimum Health Benefits for All Workers Act,", February 17, 1988, mimeo.

[4] These states together account for about 35 percent of NRECA's smaller commercial and industrial customers.

The seven sample states account for 19.3 percent of the nation's rural population.[5] The residents of these states are more likely to live in rural areas, more likely to be employed by small businesses, and less likely to have employer-provided health coverage than the rest of the nation. While 23.5 percent of the U.S. population lives in nonmetropolitan areas (as defined by the U.S. Office of Management and Budget), six of the sample states are from one-third to nearly three-quarters rural. In the nation as a whole, 66 percent of the nonelderly employed population is covered through an employer-provided plan, either

Table 2.

Employer-Provided Health Coverage Rates
and Nonmetropolitan Population
in NRECA Sample States, 1985
(in percents)

State	Employer Health Coverage	Nonmetropolitan Population
Colorado	68.1	18.8
Georgia	65.2	36.1
Kansas	69.2	49.9
Kentucky	62.0	54.5
Mississippi	57.6	70.6
Oklahoma	59.0	41.7
Tennessee	60.9	33.4
United States	66.0	23.5

Source: Author's compilations based on Employee Benefit Research Institute (EBRI), "A Profile of the Nonelderly Population without Health Insurance," EBRI Issue Brief No. 66, May 1987, and U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States 1987, Table 33.

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[5] Author's calculations based on U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States 1987, Table 33.

as an employee or as a dependent of an employee.[6] Of the sample states, only two states have employer-provided coverage rates that meet or exceed the national rate.

THE COVERED POPULATION

Employees in rural small businesses are significantly less likely to have access to employer-provided health coverage than the workforce as a whole. Nationally, 82.5 percent of all employees and 95 percent of full-time employees in medium and large firms (generally 100 employees and larger, depending on the industry) are covered by an employer-sponsored plan (Table 3 and Figure 1). By comparison, 64.7 percent of the employees in the NRECA sample were covered by an employer-sponsored plan.

Part-time employees are somewhat more likely to be covered in smaller rural firms than nationwide.[7] In the NRECA sample, 22.6 percent of those covered were in plans that covered part-time employees (Table 3). By comparison, 19.5 percent of all part-time employees nationwide receive direct coverage from their employer. This difference could reflect the fact that smaller firms that do not buy coverage at community rates may need to cover part-time employees to achieve a risk pool of adequate size.

Dependents' coverage is almost universally available in medium and large firms that offer coverage, though an employee contribution to such coverage is usually required. Nearly 6 percent of covered employees in smaller rural firms are in plans that do not provide for dependents' coverage (Table 3).

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[6] EBRI, op. cit. The 1985 Current Population Survey (CPS), on which this statistic is based, was conducted before the tax code provisions were enacted that gave former employees, retirees, their spouses and dependents, and certain former spouses the right to continuation coverage under their former employer's plan. Thus, the CPS would not pick up coverage of former employees as employer-provided coverage.

[7] National data define a part-time employee as one working less than 35 hours in a typical week. The NRECA questionnaire did not specify a definition of part-time employee for respondents to use.

Table 3.

Health Coverage Rates and Cost-Sharing
in Rural Small Firms Compared with National Totals
(in percents)

Group	Rural Small Businesses	National Totals
Employees participating in plans	64.7	82.6 to 95.0 a/
Percent of participants in plans covering:		
Part-time employees	22.6	19.5 b/
Dependents	93.3	100.0 c/
Retirees	46.9	76.0 c/
Who pays premiums (employee coverage):		
Employer	43.6	56.8 c/
Employee	8.0	d/
Shared	48.8	43.2 c/

Sources: Rural data from NRECA survey. National totals from: U.S. Department of Labor, Bureau of Labor Statistics (BLS), Employee Benefits in Medium and Large Firms, 1986 (Washington, D.C.: U.S. Government Printing Office, 1987); and Employee Benefit Research Institute (EBRI), "A Profile of the Nonelderly Population without Health Insurance," EBRI Issue Brief No. 66, May 1987, as noted.

a/ The lower figure includes all workers covered directly or indirectly (EBRI); the second figure includes only full-time workers in medium and large firms covered directly (BLS).

b/ Employees are considered part-time if they worked less than 35 hours in a typical week. This figure represents the share of all part-time workers reporting direct coverage from an employer (EBRI). Some part-time employees with direct coverage available to them may instead be covered through a family member's plan and would not be counted in this total.

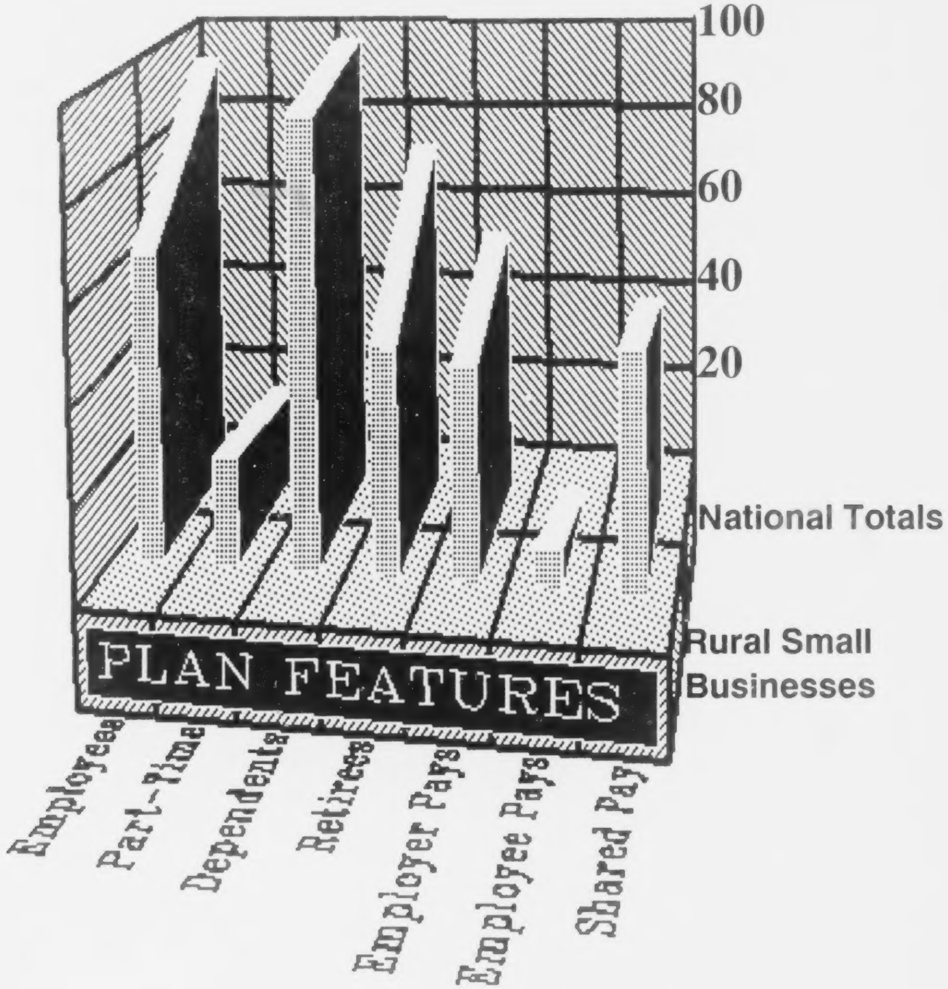
c/ BLS data.

d/ These plans are not included in the BLS survey. Other survey data suggest that fully employee-paid plans are relatively uncommon (see text).

FIGURE 1

Health Coverage Rates and Cost Sharing Rural Small Firms Compared with National Totals

(in Percents)



Retirees are much less likely to be eligible for coverage in smaller rural employers' plans than nationwide.[8] BLS data show that 76.0 percent of covered employees participate in plans that offer continued participation after retirement. By comparison, 46.9 percent of covered employees in the NRECA sample participated in such plans.

The share of employers requiring employee contributions to premium costs has been increasing in recent years, but smaller rural employers are ahead of this trend. Employees in smaller rural firms are more likely to contribute to their coverage when it is available. BLS data show that 43 percent of covered employees contributed to the cost of their own coverage (Table 3).[9] By comparison, 56.8 percent of covered employees in smaller rural firms paid all or part of the premiums for their coverage.

The most dramatic difference in cost-sharing between rural firms and others is in the proportion of employees paying the entire cost of their coverage. The BLS survey does not consider employee-paid coverage an employer-provided benefit, and thus does not tabulate the percentage of employees in this category. Other data sources suggest, however, that employee-paid plans in medium and large firms are rare.[10]

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[8] The Consolidated Omnibus Budget Reconciliation Act of 1986 provides that plan sponsors must make continuation coverage available for up to 18 months at group rates to separated employees, including retirees, and their dependents. The law does not require that retirees be permanently eligible for coverage.

[9] Nationwide, employers are more likely to require employee contributions to the cost of dependents' coverage, and, where such contributions are required, they are a larger share of premium cost than are contributions to the employee's own coverage. The NRECA survey did not ask about contributions to dependents' coverage.

[10] See, for example, A. Foster Higgins & Co., Inc., Foster Higgins Health Care Benefits Survey 1987 (Princeton, N.J., 1987). The Foster Higgins survey found that 2 percent of medium and large employers required employee contributions of 51 to 100 percent of employee-only coverage. Among employers requiring any employee contributions, the average employee-paid share of the premium was 21.7 percent (p. 12A).

Just as smaller firms differ from larger ones, they also differ from each other. Coverage rates increase with firm size (Table 4 and Figure 2). Coverage rates are lowest in firms with fewer than five employees: 35.6 percent of employees in firms with one to four employees are covered by health coverage plans, compared with 58.7 percent in firms with five to nine employees. In firms with 25 to 60 employees, 73.2 percent of employees are covered by an employer plan. This is double the coverage rate in the smallest firms, though still below national coverage rates.

Table 4.

Coverage Rates by Participant Group and Size of Firm
(In Percents)

	Size of Firm			
Participant Group	1 to 4	5 to 9	10 to 24	25 to 60
Full-time employees	35.6	58.7	63.9	73.2
Part-time employees a/	18.6	28.7	17.0	24.4
Dependents a/	79.1	88.3	94.7	95.1
Retirees a/	19.2	19.1	34.0	61.0

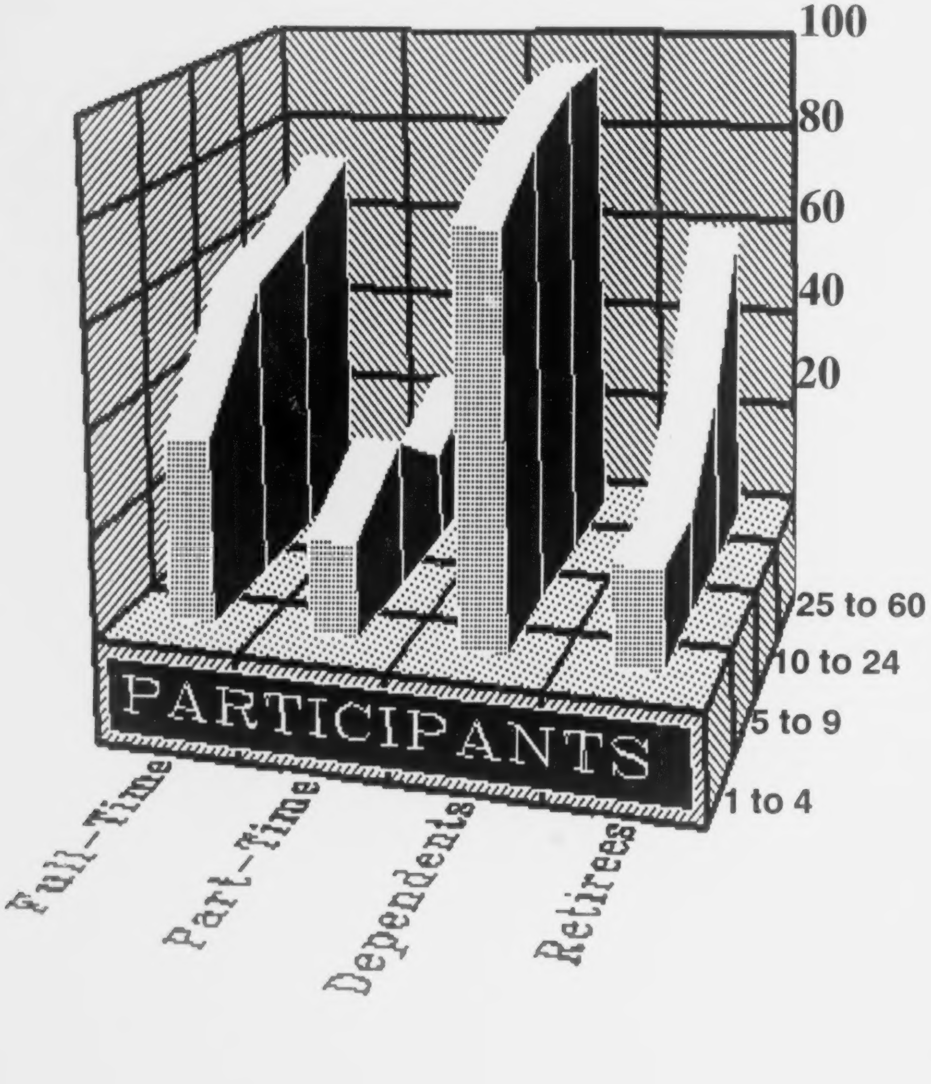
Source: NRECA Survey.

a/ Percents represent the share of full-time employees covered under plans in which the designated groups are eligible to participate. If the respondent did not indicate whether a particular group was eligible to participate, that employer's plan was treated as not including the designated group.

FIGURE 2

Coverage Rates by Participant Group and Size of Firm

(In Percents)



Many employees are covered by employer-sponsored health plans through another employed family member, generally a spouse. In 1985, nearly 20 percent of all employees with employer-provided coverage were covered indirectly.[11] Since the NRECA survey was based on interviews with employers, evidence on the availability of indirect coverage is not available. However, dependents' coverage is less prevalent in small firms than in larger employers' plans. To the extent that rural areas are more dependent for employment on smaller firms, this suggests that, at least in rural areas, secondary coverage may be less available as well. This may make lack of employer-provided coverage a more serious problem.

Coverage rates differ considerably among rural industry sectors. The lowest coverage rate in the NRECA sample was observed in retail trade firms, with 45.0 percent of employers offering a health coverage plan (Table 4). By contrast, 81.5 percent of employers in finance, insurance, and real estate offered health coverage. While manufacturing tends to be a high-coverage sector nationwide,[12] slightly more than half of rural manufacturing firms in the NRECA sample offered health coverage.

As a smaller firm becomes more established, it is more likely to offer a health coverage plan. The share of employers in the NRECA sample offering coverage increased from 40.3 percent of those in business two years or less to 69.3 percent of those in business 20 years or more (Table 5). The largest increase in coverage rates occurs after an employer has been in business more than 10 years. The proportion of employers offering coverage rises from 48.2 percent of those in business 6 to 10 years to 64.2 percent of those in business 11 to 20 years, for an increase of 25 percent.

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[11] EBRI, op. cit., Table 11.

[12] EBRI, Table 5.

WHY DO EMPLOYERS OFFER COVERAGE?

Employers offer coverage because they feel they need to do so. Three of the top four reasons for offering coverage could be considered market or competitive reasons: the fact that coverage is part of the benefits package, the employer's perception that employees need coverage, and the need to compete for good employees (Table 6).

Costs and related considerations, in turn, were the three least important reasons employers cited for offering coverage. Fewer than 3 percent of employees were covered by employers who cited getting coverage or group rates for plan founders or better rates for employees as the reason for offering their employees coverage.

THE ROLE OF COSTS IN EMPLOYER DECISION-MAKING

Costs influence both the employer's choice of plans and the decision to change plans. Almost 60 percent of the employers who offered health coverage cited cost as the dominant factor in the

Table 5.

Health Coverage Rates Among Employers
by Industry and Age of Firm
(in percents)

Firm Characteristic	Employers Offering Health Coverage
Industry:	
Manufacturing	58.7
Wholesale trade	76.7
Retail trade	45.0
Finance, insurance, and real estate	81.5
Services	58.7
Age of firm:	
2 years or less	40.3
3 to 5 years	45.3
6 to 10 years	48.2
11 to 20 years	64.2
20 years or more	69.3
All firms	56.3

Source: NRECA Survey.

Table 6.

Employees and Employers With Health Coverage
by Employer's Reason for Offering Coverage
(in percents)

Reason	Employees	Employers
Part of the package	31.9	31.5
Employees need coverage	30.5	29.0
Moral obligation	19.0	12.9
To compete for good employees	13.0	12.2
To have a healthy, productive workforce	8.6	5.2
Owner wanted coverage	2.7	7.2
To get group rates for company founders	2.3	1.5
To get group rates for employees	1.9	2.5

Source: NRECA Survey.

choice of plan (Table 7). Over one-third of employers chose their plan for the coverage or benefits it offered, though fewer than 2 percent cited specific features like major medical provisions or deductibles. Employers thus see cost as more important than plan features in choosing a plan, and seem to consider features as a package rather than in isolation.

Cost is also important in plan changes, and small employers are fairly mobile among plans. Nearly half of the employers offering plans reported that they had changed plans at some point, and nearly 52 percent had used their current health care provider for less than 5 years. Of those reporting that they had changed plans, 40 percent did so for cost reasons (Table 7). Policy-makers have been concerned with the administrative burden universal health coverage would impose on smaller employers. Among rural small employers who offer coverage, administrative ease was not a major factor in either the choice of plan or the decision to change plans. Only 5.4 percent of employers cited this as a factor in plan choice and 3.5 percent considered this in changing plans.

The quality of agent or company service was far more important; nearly 18 percent of employers cited this as a factor in plan choice. The quality of service could influence administrative ease, reducing employers' burden of maintaining plans in ways that are not easily quantified.

The importance of service to smaller employers is underscored by the fact that 45.8 percent of the sample employers with coverage reported that they generally deal with their insurance agent on health coverage matters, rather than directly with the company or other parties. If the regional insurance pools proposed under S. 1265 reduce the quality of attention and service plan sponsors receive from health coverage vendors, employers' administrative burden of providing health coverage will increase. This increased burden could increase operating costs and offset the pools' cost advantages.

COVERAGE OFFERED BY SMALL RURAL EMPLOYERS

The plans offered by rural employers reflect their cost concerns. The NRECA data do not allow direct comparison with national patterns, since actual employee enrollment by type of plan is not known. However, rural employers are very interested in managed-care arrangements, particularly preferred provider organizations (PPOs). PPOs are networks of health care providers

Table 7.

Employers' Major Reasons for Choosing and Changing Plans
(in percents)

Reason	Choice of Plan	Change of Plan
Cost	59.3	37.8
Coverage or benefits desired	29.9	4.1
Quality of agent or company service	17.9	5.2
Administrative ease	5.4	3.5

Source: NRECA Survey.

Notes: Respondents could cite more than one reason for each decision.

(doctors, hospitals, etc.) who agree to provide plan sponsors with reduced rates in return for employee referrals. Nearly 5 percent of the employees with coverage available to them could select a health maintenance organization (HMO), and nearly 7 percent could enroll in a PPO (Table 8). Nationwide, 13 percent of health insurance plan participants are enrolled in HMOs and about 1 percent participate in PPOs.[13]

In other respects, the provider choices of smaller rural employers resemble those of larger employers. The majority of small rural employers offer traditional indemnity plans, just as the majority of employees with health coverage nationwide are covered under such plans. Likewise, 31.5 percent of the employers in the sample used Blue Cross-Blue Shield as a carrier, while 28 percent of employees are covered under the Blues' plans nationwide.

Table 8.

Employees With Coverage
By Type of Plan Available and Firm Size
(in percents)

Size Category	Indemnity	HMO	PPO
1 to 4	68.1	3.8	6.0
5 to 9	68.1	5.3	4.3
10 to 24	71.3	7.4	7.4
25 to 60	78.0	3.7	7.3
All firms	74.6	4.8	6.9

Source: NRECA Survey.

Notes: Employers could offer more than one response, so percents are not additive.

Data for employers who offered other plans or did not respond to the question are not displayed in the table.

As noted earlier, the sensitivity of smaller employers to health coverage costs promotes greater cost-sharing by employees. Employee-paid plans are most prevalent in the smallest firms.

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[13] U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms 1986 (Washington, D.C.: U.S. Government Printing Office, 1987), p. 31.

Nearly 20 percent of the covered employees in firms with fewer than 5 employees paid the entire cost of their plans, compared with 10.6 percent in firms with 5 to 9 employees and 6.1 percent in firms with 25 to 60 employees (Table 9 and Figure 3). This distribution suggests that the cost-sharing provisions in S.1265 will have their most adverse effects on the smallest firms with the lowest coverage rates.

THE POPULATION WITHOUT COVERAGE

The greatest coverage gaps occur in the smallest firms. Firms with fewer than 10 employees accounted for a larger share of the sample's noncovered population than their share of the sample's employment. These firms accounted for 23 percent of the sample's employees and 46 percent of its noncovered workers. The relative importance of these employers in the noncoverage problem is even greater when coverage is measured at the firm, rather than the employee, level. Firms with fewer than 10 employees accounted for 72 percent of the firms in the sample, but 88 percent of the firms not offering health coverage.[14]

Table 9.

Employees With Coverage
by Premium-Sharing Arrangements and Firm Size
(in percents)

Firm Size	Employer Pays All	Employee Pays All	Cost is Shared
1 to 4	56.7	19.5	23.8
5 to 9	56.9	10.3	33.8
10 to 24	46.6	7.8	45.6
25 to 60	38.1	6.0	56.0
All Firms	43.6	8.0	48.8

Source: NRECA Survey.

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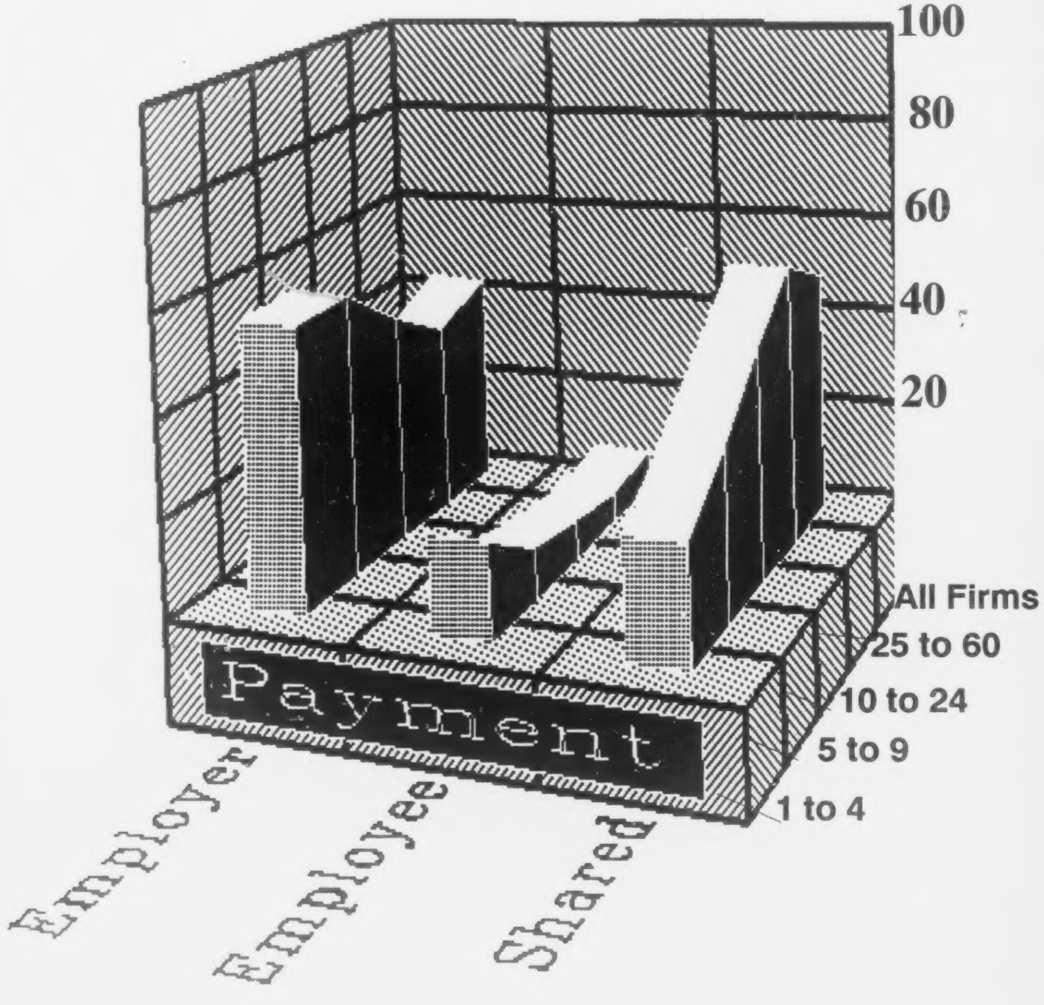
[14] Author's calculations based on NRECA Survey.

FIGURE 3.

Employees by Health Coverage Premium-Sharing Arrangements and Firm Size

(In Percents)



Why Employers Do Not Offer Coverage

Employers without health coverage plans consider cost the most important barrier to offering coverage. Cost to the company was cited by 27.2 percent of the employers not offering coverage, with 29.9 percent of the noncovered employees (Table 10). Cost to the employee was cited by 3.6 percent of the employers, accounting for 12.1 percent of the noncovered employees. Cost could also contribute to other reasons for not offering coverage. For example, high employee turnover, cited by 6.5 percent of the employers without coverage, can increase the cost of offering a plan.

Some employers do not offer coverage because they feel that employees do not need it, perhaps because they can get coverage from other sources. Thirty-eight percent of the employers not offering coverage, with 24.5 percent of the noncovered employees, cited this as a reason (Table 10). As discussed earlier, secondary coverage may be less available in rural areas than nationwide.

Table 10.

Employees and Employers Without Health Coverage by Employer's Reason for Not Offering Coverage (in percents)

Reason	Employees	Employers
Cost to company	29.9	27.2
Don't need/have alternative coverage	24.5	38.0
High employee turnover	15.3	6.5
Cost to employee	12.1	3.6
Lack of employee interest	6.8	2.9
Lack of available health care plans	0.8	2.0
Administrative burden	0.9	0.4
Other	22.5	33.2

Source: NRECA Survey.

Only 2.0 percent of the employers without coverage failed to offer it because of plan availability. This could suggest the presence of marketing and information gaps, particularly since all the employers citing this reason had fewer than 5 employees.

Incentives to Offering Coverage

A firm's economic performance seems to influence the decision to offer coverage. A significant share of the employees without coverage could acquire it in the near future even without changes in legislation. Nearly 17 percent of the employers who do not offer coverage, with 14.4 percent of the noncovered employees, expected to offer health coverage in the next 12 to 18 months. Twenty-two percent of the employers without coverage said company growth could prompt them to offer coverage, while 17.2 percent cited improved company performance as a potential incentive (Table 11). Increased employee demand or improved plan affordability were not considered important stimuli.

Economic growth can have two different effects on coverage rates, however. While growth may increase coverage in existing firms, it will also prompt the emergence of some new firms

Table 11.

Employers Expecting to Offer Coverage in the Near Term a/
(in percents of employers and employees affected b/)

Incentive for Offering Coverage	Employees	Employers
Company growth	3.2	22.0
Improved company performance	3.3	17.2
Increased employee demand	c/	4.8
Improved affordability	c/	2.4

Source: NRECA Survey.

a/ Statistics are based on the number of employers without coverage who indicated that they were likely to offer coverage in the next 12 to 18 months.

b/ Calculated as the percentage of employees and employers without health coverage.

c/ Less than 1 percent.

without coverage. It is therefore not likely that the economy will simply grow its way out of health coverage gaps.

CONCLUSIONS AND POLICY IMPLICATIONS

The report's major findings concern the special features of health coverage patterns and employer decision-making in smaller rural businesses.

Health Coverage Patterns

Health coverage rates in smaller rural nonagricultural businesses are significantly lower than in the economy as a whole. In addition, covered employees lack several of the safety net features of employer-provided coverage available in medium and large firms; retirees and dependents are much less likely to be eligible for coverage. Employees are more likely to contribute to the plan's premium costs, and a significant share of employees pay the entire plan cost. In particular, one in five of the smallest firms' covered employees pay the entire cost of the plan. Lack of health coverage in nonagricultural rural businesses is largely a problem of the smallest and newest firms. In the NRECA sample, firms with fewer than 10 employees accounted for 88 percent of the firms without coverage and 46 percent of the noncovered employees, while those in business less than 2 years accounted for nearly 22 percent of the employers without coverage.

Employer Decision-Making

Cost is the major barrier employers face in deciding to offer coverage and their dominant consideration in choosing and changing plans. Smaller employers also value the quality of the provider's service, however. The quality of service may be a proxy for ease of plan administration, with better service making plan administration easier. As a firm's economic performance improves, the likelihood that it will offer coverage increases. Thus, the problems facing small businesses everywhere and rural economies in particular are probably retarding voluntary coverage expansion.

Policy Implications

The results of this study have implications for the treatment of small firms under universal health coverage initiatives and under COBRA and Internal Revenue Code section 89.

Small firms under universal health coverage. The Senate bill compromises between the goals of expanding coverage and minimizing the burden on the weakest employers by offering relief for smaller and newer firms. It also could reduce costs for some employers. However, the bill would leave coverage gaps and the cost relief would accrue to those employers who already offer coverage.

The bill would allow employers with fewer than 10 employees who have been in business less than two years to offer only catastrophic coverage and those with fewer than 5 employees to phase in coverage over five years, offering catastrophic coverage after three years. This relief recognizes these firms' lower wage scales and greater financial instability. The NRECA data suggest that the Senate bill draws the right compromise to minimize the burden on the smallest and newest firms, since coverage rates are significantly lower below the S. 1265 cutoff levels (see Tables 4 and 5).

Coverage relief for smaller firms also reduces the bill's net impact, however. The S. 1265 relief could permit limited coverage for as many as 46 percent of the employees and 88 percent of the employers without coverage in the NRECA sample.[15] Thus, some coverage gaps and some of the costs of uncompensated care would remain.

S. 1265 could reduce costs for some smaller employers who already offer coverage by reducing the administrative component of premium costs through the risk pools, encouraging greater employee cost-sharing, and eliminating state benefit mandates form the required minimum benefit. However, those employers who do not now contribute to coverage, whose cost-sharing provisions would be reduced or eliminated, or who offer less-generous benefits than the proposal requires would find their costs significantly increased.

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[15] Not all these employees are in firms that would be exempt from the requirements of S. 1265. The structure of the NRECA sample does not permit reliable estimates of firms jointly by both size and length of time in business, however.

An alternative way to provide cost relief for smaller firms while still expanding coverage could be to provide a direct subsidy to smaller, newer, and low-wage firms. This subsidy could offer employers a tax credit for some share of health coverage costs or an opportunity to buy the minimum benefit package at subsidized rates. This alternative could do more than S.1265 to fill existing coverage gaps and lower the cost of coverage, but would need to be financed through some other source of revenue.

Full deductibility of health coverage premiums for self-employed individuals would also provide cost relief for many smaller firms. The Tax Reform Act of 1986 provided that self-employed individuals who provide coverage for employees on a nondiscriminatory basis may deduct 25 percent of the cost of coverage from adjusted gross income. Other employers, in contrast, may deduct the full amount of such premiums from adjusted gross income.

If the self-employed are to be subject to the same coverage requirements as all other employers, it would seem appropriate that they have access to the same tax benefits. The cost implementing coverage or reducing employee cost-sharing will only partly be offset by full deductibility, since many smaller and newer businesses may not face tax liability. The lack of tax liability for many smaller businesses, in turn, will limit the federal revenue cost of this provision.

Small firms under COBRA and section 89. Under the Consolidated Omnibus Reconciliation Act of 1985 (COBRA) and section 89 enacted in the Tax Reform Act of 1986 (TRA), sponsors of health coverage plans must comply with new coverage, benefit, and reporting requirements. The NRECA survey suggests that costs and administrative burdens impede the expansion of health coverage. If universal coverage is enacted, these requirements could be modified for smaller firms.

o Modifying COBRA coverage continuation requirements. COBRA requires that all employers with more than 20 employees who offer health coverage extend coverage to employees and certain dependents whose coverage would otherwise end as a result of certain events. These events include unemployment, death, or retirement of the employee, and divorce. Employees may be eligible for continuation coverage under COBRA even if they are hired by another employer.

COBRA imposes stringent record-keeping and notification requirements. Given the strong sensitivity of smaller employers to costs and administrative burdens, these requirements may constitute an additional deterrent to voluntary coverage expansion. Once most employers are required to offer benefits equivalent to the minimum benefit package, COBRA eligibility for reemployed former employees would be largely redundant, though coverage for dependents and retirees could still be needed.

o Simplifying the IRC section 89 nondiscrimination tests. TRA imposed complex new nondiscrimination rules governing eligibility and benefits in welfare plans. These tests are largely redundant with the eligibility and benefits provisions in S. 1265 for firms offering no more than one plan for all employees. The section 89 reporting requirements thus could be simplified for smaller firms.

Under section 89, plans must meet a three-part eligibility test and a benefits test, or may elect to use an alternative test in lieu of the eligibility and benefits tests. Under the eligibility tests:

- either nonhighly compensated employees must constitute at least 50 percent of eligible employees, or the share of highly compensated employees eligible to participate must be no higher than the share of nonhighly compensated employees eligible;

- at least 90 percent of nonhighly compensated employees must be eligible to participate in the plan or another health plan offered by the employer, and if they did participate, would receive a benefit that is at least 50 percent as valuable as the most valuable benefit available to any highly compensated employee; and
- no eligibility provisions may in any way discriminate in favor of highly compensated employees.

The benefits test provides that nonhighly compensated employees must receive an average benefit equal to at least 75 percent of the average benefit provided to highly compensated employees. Under the alternative test, a plan that benefits at least 80 percent of nonhighly compensated employees satisfies both the eligibility and benefits tests, provided that employees are not just eligible but actually receive coverage.

A plan that covers at least 80 percent of the employer's rank-and-file employees would be exempt from performing the eligibility and benefits tests, but not from documentation and reporting requirements.[16] Failure to comply with the documentation and reporting requirements of section 89(k) can mean that employees must include in income the value of benefits received under the plan.

The section 89 rules are intended to limit the degree to which tax incentives disproportionately subsidize benefits for highly-paid employees. S. 1265 also contains eligibility and employer contribution requirements that serve to fix the distribution and value of the benefits provided.

If S. 1265 were in place, the documentation and reporting requirements would not be as critical for smaller firms offering only one plan, since available coverage and eligibility requirements would be fairly standard among employers. Consequently, if S. 1265 were enacted into law, the reporting and record-keeping burdens of section 89 could be simplified for smaller employers by providing that employers who cover all employees under one plan and comply with the provisions of S. 1265 are exempt from the section 89(k) sanctions.

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[16] Section 89(k)(1) provides that plans must be in writing, employee rights must be legally enforceable, employees must be provided reasonable notification of available benefits, the plan must be maintained for the exclusive benefit of employees, and the plan must be established with the intention of being maintained for an indefinite period of time.

In summary, smaller rural firms face certain unique barriers to offering health coverage. Imposing universal coverage requirements would create new costs and administrative difficulties for these firms, jeopardizing the survival of many. Providing relief from recently-enacted reporting coverage and reporting requirements as well as permitting full tax deductibility of premiums for the self-employed would lessen some of these burdens and promote equity for smaller firms.

APPENDIX: Presenting the NRECA Survey Data

This appendix explains how the data in this report were derived from the NRECA survey. Three issues should be considered in interpreting the NRECA data:

- the derivation of the data on employee coverage;
- how employer-based and employee-based data differ in interpretation; and
- how data on coverage rates and coverage features should be interpreted.

Deriving Data on Employees

The NRECA survey used the employer as the unit of observation. National coverage data, in contrast, report the share of employees or other individuals covered in various categories. To allow comparison with national coverage data, the statistics reported were recalculated to use the employee as the unit of observation.

For this recalculation, the number of firms in each category was multiplied by the midpoint of that size range. For example, if five employers in the 10 to 24 employee category responded that they offered coverage, 85 employees (5 x 17) were noted as having that coverage. This figure was then divided by the total number of employees in that category to derive the percentage of employees in that firm category with coverage. Thus, if there were 10 firms with 10 to 24 employees, the coverage rate in this example would be 50 percent (85/(10 x 17)).

This approach will generally yield correct estimates of the number of employees in each category if firms are not clustered to one or the other end of the size range. Since the firm size ranges in the NRECA survey were narrow, this was not considered to be a problem.

Interpreting Employer and Employee Data

Some of the data in the report are presented in terms of the percentage of employers meeting certain criteria, some in terms of employees, and some are presented both ways. Employer and employee data provide different pictures of coverage.

Employer-based data understate the relative importance of larger employers, since each employer counts equally, whether it employs 5 people or 60. Employer data do, however, tell us how many decision-makers are involved in each coverage category.

Employee-based data allow comparability with Census and BLS data. Employee data also tell us the potential burden of lack of coverage patterns on the health care system. Employee data, on the other hand, do not tell us whether employees are working in sectors that are difficult to cover, like smaller businesses.

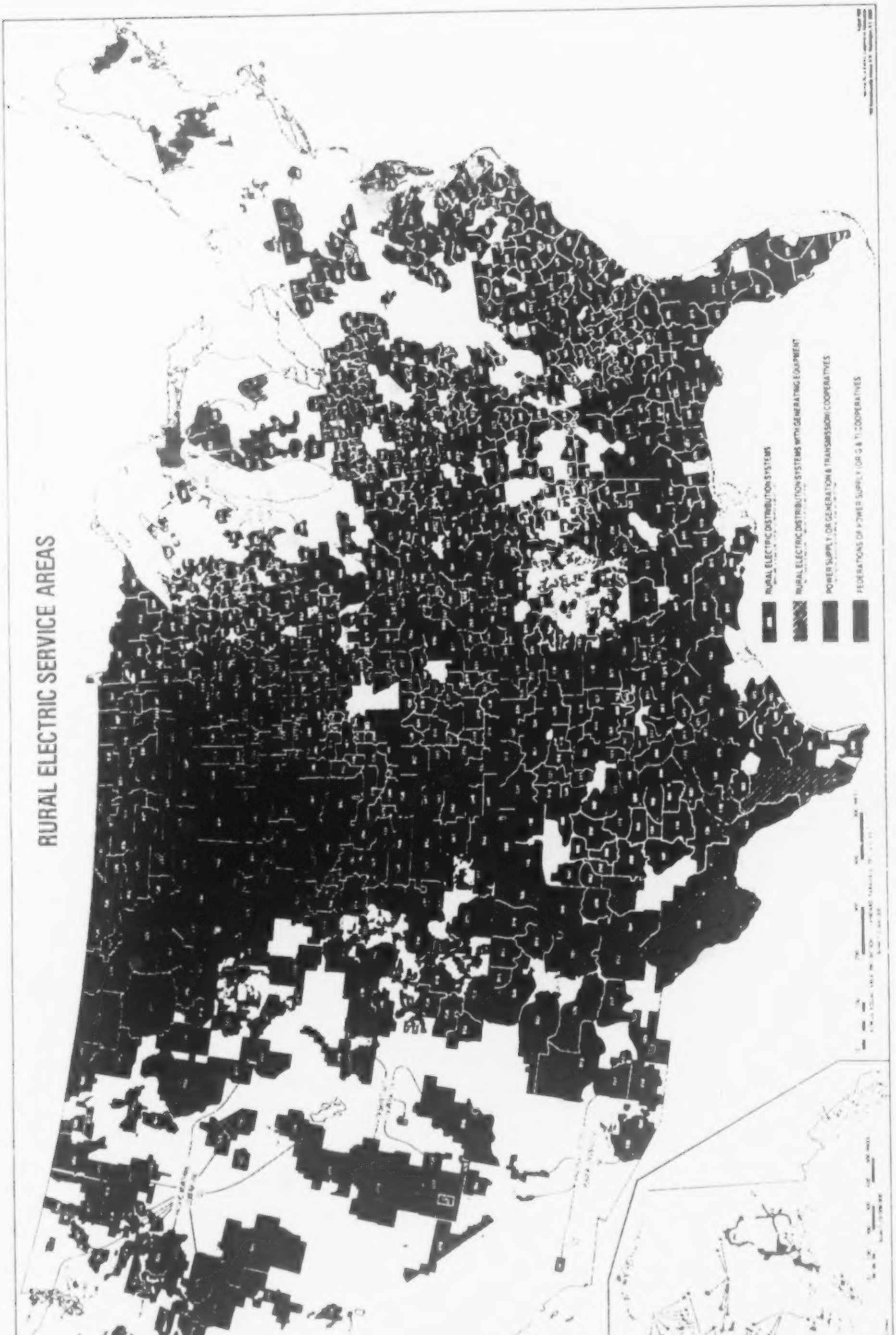
Coverage Data and Coverage Features

The percentage of employees with coverage is calculated as a share of all employees. In contrast, the share of employees with specific coverage features -- such as various cost-sharing arrangements -- is calculated on the basis of only those employees with coverage. Likewise, employers' reasons for offering coverage are tabulated on the basis of only those employers who offer coverage, rather than the whole employer base.12

ABOUT THE SURVEY

Sophie Korczyk is a Washington, D.C., economist who has published extensively on the economics of pensions and other employee benefits. She was formerly a Senior Research Associate at the Employee Benefit Research Institute and Director of Benefits Research at Peat Marwick.

The mission of the National Rural Electric Cooperative Association is to serve, represent and provide leadership to cooperative/consumer-owned rural electric systems and allied organizations in their efforts to enhance the quality of life in their communities. The approximately 1,000 rural electric systems operating in 46 states serve over 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Various programs administered by NRECA provide pension and welfare benefits to over 125,000 rural electric employees, dependents, directors and consumer-members in those localities.


RURAL ELECTRIC SERVICE AREAS
RURAL ELECTRIC DISTRIBUTION SYSTEMS
RURAL ELECTRIC DISTRIBUTION SYSTEMS WITH GENERATING EQUIPMENT
POWER SUPPLY (OR GENERATION & TRANSMISSION) COOPERATIVES
FEDERATIONS OF POWER SUPPLY (OR G & T) COOPERATIVES

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COMMITTEE ON FINANCE
UNITED STATES SENATE

Testimony of Nelson Stephenson

July 13, 1988

The Technical Corrections Act of 1988 and
Additions Thereto by the Committee
on Ways and Means

My name is Nelson Stephenson, Senior Executive Vice President and Chief Financial Officer of the East River Savings Bank of New Rochelle, New York with $2.7 billion in assets as of June 30, 1988. I am here to testify on behalf of the National Council of Savings Institutions and the U.S. League of Savings Institutions on a matter of great concern to our members. Specifically, I want to urge the Committee to preserve the current 70 percent dividends received deduction for portfolio investments provided by section 243 of the Internal Revenue Code.

I note that the House Ways and Means Committee is considering a proposal to reduce the dividends received deduction for a corporation owning less than 20 percent of the stock of a distributing corporation to 50 percent. It is my understanding that the driving force behind the proposal is to raise revenues so that expiring provisions, such as the research and development credit and others, can be extended. I believe the proposal is poor tax policy, and I know its implementation would be harmful to the savings industry.

I. Historical Basis for the Dividends Received Deduction

Traditionally, the United States has employed a two-tiered corporate tax system, taxing income once to the corporation when earned and once to individual shareholders when distributed. Since 1917 the law has allowed a dividends received deduction to eliminate or minimize further multiples of taxation of corporate earnings as the earnings pass from one corporation to another. Providing another round of tax on dividends remaining in corporate solution, when the issuer has already been taxed on the earnings, has rightly been viewed as imposing unjustified additional tiers of tax on earnings at the corporate level, before the earnings are distributed to individuals. Without a dividends received deduction, the situation would be exacerbated for dividends passing through a chain of corporate shareholders and a multiple of cascading corporate tax, before coming to rest in the hands of the individual who pays tax on the dividends pursuant to the individual tax tier of the system. Such a result would not serve the purpose of the corporate tax system.

A 100 percent dividends received deduction applied from 1917 to 1935. An 85 percent deduction was in effect from 1936 through 1986 for all corporations (other than affiliated groups which beginning in 1963 were again allowed a full deduction). The reduction in the dividends received deduction made in 1936 was meant to discourage the abuse of the graduated corporate tax rates and multiple surcharge exemptions. It did not represent a departure from the policy of taxing earnings only once while in corporate solution.

The two-tiered system of corporate taxation was strengthened by the 1986 Tax Reform Act with its repeal of the General Utilities doctrine. The 1986 Act did reduce the deduction for dividends received from non-affiliated corporations from 85 percent to 80 percent. Congress took this action in 1986 only in order to retain the same effective tax rate on dividends. In the absence of the reduction, the marginal corporate tax rate reductions of the 1986 Act would have resulted in a reduction of the effective tax rate on dividends. The change in the deduction did not represent a departure from the historical policy of mitigating multiple taxation of corporate earnings.

The current proposal to change the dividends received deduction affects only "portfolio" investments by corporations, those that own less than 20 percent of the shares of the dividend paying corporation. No change has been proposed to the 80 percent deduction allowed to corporations owning more than 20 percent but less than 80 percent. Likewise, no change has been proposed for the full deduction for 80 percent or more corporate owners. The differentiation between portfolio investments and other corporate stock ownership is a revenue-driven distinction not appearing in the tax law until the Omnibus Budget Reconciliation Act of 1987. The prospect of double taxation, and more, at the corporate level is just as great for corporate portfolio holdings as it is at levels representing larger corporate ownerhip.

II. Impact on Corporate Financing Strategy

Reducing the dividend received deduction adversely affects every shareholder, both corporate and individual. This action drastically changes the system of corporate finance which has served us so well. Such changes should only be made after thorough study and extensive evaluation of the impact. To reduce the dividend received deduction for the sole reason of raising revenues to fund other special tax provisions makes little sense. Preserving the integrity of the corporate tax system which affects a wide range of existing companies is a far more important objective.

III. Impact on Savings Institutions

With respect to the savings institutions industry, this proposal comes at a particularly bad time. We need to encourage corporate investment in our institutions to maintain and stregthen our capital positions. This is particularly important in view of the recent proposals by both domestic and international regulators to increase the amount of capital required for financial institutions. A reduction in the deduction could cause loyal corporate shareholders to dispose of their shares. Indeed, some of our preferred stock is subject to mandatory redemption provisions that are required if there is an increase in the tax burden on corporate holders. As you know, savings institutions are going through a difficult restructuring period. This proposal would only worsen our already severe problems by increasing the cost of capital for our industry.

IV. Fairness Calls for Prospective Application

If the dividends received deduction for portfolio investments must be reduced, in the interest of fairness the reduction should be on a prospective basis only, i.e., for stock issued after a definitive date of decision by both of the tax writing committees. Corporations have made significant long-term financial investment decisions, based in large part on the availability of the present deduction. They should not be penalized now by a change of law, especially when the change is counter to over 70 years of corporate tax policy. There is ample precedent for protecting current stockholders in such a manner. For instance, when the law affecting property and casualty insurance companies was recently changed, section 1022 of the Tax Reform Act of 1986 provided that the new proration rule for dividends received by those companies would not be applied to dividends received or accrued on stock acquired before August 8, 1986.

V. Conclusion

Again, I ask that this Committee preserve undiminished the dividends received deduction for portfolio investments. If a reduction has to be made, I urge that the reduction not be retroactive to stock currently outstanding.

I have appreciated this opportunity to discuss this issue of great interest to savings institutions and the corporate community. I look forward to your questions.

STATEMENT OF THE
NATIONAL ASSOCIATION OF HOME BUILDERS
on
H.R.4333 - TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986

JULY 13, 1988

Mr. Chairman and Members of the Committee:

My name is Dale Stuard. I am from Newport Beach, California, and currently serve as President of the National Association of Home Builders (NAHB). On behalf of the more than 155,000 members of NAHB, I am pleased to have the opportunity to testify on H.R.4333, which makes technical corrections to the tax law and extends various provisions of the Tax Code.

First,let me mention that I am pleased Congress is moving toward technical corrections to the Tax Reform Act of 1986. Taxpayers, the IRS and tax practitioners desperately need the clarifications that would be provided by H.R.4333. I am also pleased that the Ways and Means Committee agreed to extend the life of various expiring tax provisions, including mortgage revenue bonds and mortgage credit certificates, and the tax credit for investment in low-income housing. I am troubled, however, by some of the changes that are proposed to be made to the mortgage revenue bond program. Furthermore, I am deeply concerned about one of the revenue raising measures agreed to by the Ways and Means Committee -- the repeal of the completed contract method of accounting. In light of a recent IRS announcement, this measure could be particularly devastating for home builders.

My testimony will focus upon long-term contract accounting, mortgage revenue bonds and the low-income housing tax credit.

Long-Term Contract Accounting:

Prior to the Tax Reform Act of 1986, income and expenses attributable to long-term contracts could, at the taxpayer's election, be accounted for under one of two alternative methods:

the percentage of completion method, or the completed contract method. A long-term contract is defined as a building, installation, construction or manufacturing contract that is not completed by the end of the taxable year it is entered into.

Under the percentage of completion method, income was recognized according to the percentage of the contract completed during the taxable year. The determination of the portion of the contract completed during the taxable year could be made either by comparing the costs incurred during the year to the total estimated costs to be incurred under the contract or comparing the work performed during the year with the estimated total work to be performed.

The Tax Reform Act of 1986 and the Revenue Act of 1987 substantially tightened the accounting rules for long-term contracts. Under present law, income and deductions related to long-term contracts must be reported under one of two special long-term contract methods. The first long-term contract method is the percentage of completion method, which generally requires that net income from the contract be reported as the contract is performed. The second method (the so-called "70-30" method) requires that 70 percent of contract income be reported on the percentage of completion method and permits the other 30 percent to be reported using another permissible method (including the completed contract method). Contracts entered into before October 14, 1987, could be reported under the same type of method as the 70-30 method, but with only 40 percent of the contract income required to be reported on the percentage of completion method.

Contracts that qualify for the small contractor exception may be reported entirely under the completed contract method, the percentage of completion method or the business's overall method of accounting. Contracts qualifying for the exception are contracts to construct real estate that last less than two years and are performed by contractors with average annual gross receipts of $10 million or less. However, for purposes of the alternative minimum tax, the percentage of completion method is required for all contracts, including those covered by the small contractor exception.

As one of its revenue raising measures, the Ways and Means Committee has agreed to repeal the percentage of completion - capitalized cost method of accounting for long-term contracts. Thus, the full amount of all long-term contracts (other than contracts of small businesses exempted under present law) would be reported on the 100 percent percentage of completion method. This measure would be effective for contracts entered into on or after June 21, 1988.

Were it not for the IRS' announcement of its position in Advance Notice 88-66 (published in Internal Revenue Bulletin 1988-25 on June 20, 1988), NAHB would not be quite so concerned with the Ways and Means Committee proposal. Prior to the issuance of the IRS Notice, it was arguable that builders of custom-designed homes were performing long-term contracts if the contract spanned two or more taxable years. However, most tax practitioners took the position that non-custom homebuilders were not subject to the long-term contract rules. The rationale for this is that a home builder generally enters into a contract to sell a completed home rather than to build a home, even though a contract may be entered into prior to the start of construction. Furthermore, title and risk of loss remain primarily with the homebuilder during construction, and the deposit on the contract often is very small in relation to the total contract price.

In Advance Notice 88-66, the IRS has taken the position that the long-term contract rules will apply to tract homebuilders, as well as to builders of custom-designed homes. This position is noted, without explanation or clarification, in the following example:

> "Thus, for example, assume a taxpayer (Taxpayer B) is in the business of constructing and selling houses. Customers enter into contracts with B to purchase the houses, with such

> contracts typically providing that such purchase shall be consummated after the construction of the house is completed, and after certain other events have occurred (e.g., financing for the house is obtained). Under these facts, B is treated as constructing property under a long-term contract (as defined in Section 460(f)) with respect to any house that is under construction as of the end of a taxable year and for which a contract for sale of such house is in effect."

During consideration of the long-term contract rules of the Tax Reform Act of 1986, it is doubtful that Congress focused upon the potential application of these rules to home builders. The major focus was upon the defense contracting industry. This is evident from the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, which notes at page 527 that: "Annual receipts for certain large defense contractors reflected negative tax rates due to net operating loss carryforwards generated through use of the completed contract method in prior years."

Homebuilders, unlike many defense contractors, do not receive progress payments during the performance of a contract. Rather, a homebuilder receives a deposit when he accepts a sales contract, which is quite small in relation to the total contract price. Thus, to require the homebuilder to report on the percentage of completion method would cause substantial cash flow problems. Furthermore, as noted above, title and risk of loss generally remains with the homebuilder during the construction period.

Furthermore, application of the long-term contract rules to homebuilders would cause severe accounting and administrative complexities. For example, a volume builder would have to keep detailed records concerning the exact time that construction begins on each home, the time a sales contract is entered into on each home and the stage of construction each house is in at the end of each taxable year.

In this age of declining homeownership and increased housing costs, this simply is not the time to impose additional burdens on homebuilders. Let me just make one point about the potential for increased housing costs that would result from the application of the long-term contract rules to homebuilders. While we cannot at this time predict with any exactness how much housing costs would increase, it is clear that they would. If a homebuilder is forced to pay tax in advance of the receipt of income, the builder will have to borrow the money with which to pay the tax. In order to support larger borrowings, the builder is going to be forced to increase the prices of his homes. Thus, the question is not whether home prices will be increased, and housing affordability problems be exacerbated, the only question is by how much?

Mr. Chairman, in connection with your consideration of technical corrections, we urge you to overturn the ill-advised policy position of the IRS in Advance Announcement 88-66, and clarify that the long-term contract accounting rules do not apply to residential construction. Alternatively, we urge you to amend the Code to provide that residential construction completed within a 12-month period is not subject to the long-term contract accounting rules. Such a provision, at least, would provide a more rational distinction between what is and what is not a long-term contract.

Mortgage Revenue Bonds

Mr. Chairman, we have already testified before the Taxation and Debt Management Subcommittee (March 28, 1988) on the need for maintaining a viable mortgage revenue bond program, so my remarks today will be brief.

State and local housing finance agencies use mortgage revenue bonds to obtain tax-exempt funds at low rates of interest and these funds are used to purchase qualified mortgages. Mortgage revenue bonds make housing more affordable to homebuyers because interest rates are generally about two percentage points below conventional rates.

Mortgage credit certificates, which are subject to the same targeting requirements as mortgage revenue bonds, provide homebuyers with a tax credit equal to a percentage of mortgage interest payments. This federal tax credit increases the disposable income of home buyers and makes conventional mortgage rates more affordable. Up to 25 percent of mortgage revenue bond authority may be "traded-in" for mortgage credit certificates. Mortgage credit certificates are a new program but are proving to be an effective complement to the mortgage revenue bond program.

Members of the Committee, the problem we face is simple yet devastating:

> With spiraling housing costs and with federal housing funds decreasing, many young, hard-working Americans cannot buy a home; since 1980, the homeownership rate has dropped 20 percent among young families 25 to 34 years of age. The homeless population is increasing and many of the homeless are families who cannot afford a place to live within their limited resources. Elderly couples are living in substandard conditions because the cost of financing home repairs would deprive them of other basic necessities. These are not exaggerations; this is becoming a part of life in America that some want to ignore.

Though not a solution to this growing problem, mortgage revenue bonds do provide affordable housing options for these struggling, first-time homebuyers. Actually, mortgage revenue bonds and mortgage credit certificates are the only assistance provided through the Internal Revenue Code that specifically target low- and moderate-income, first-time homebuyers.

Mortgage revenue bonds have made a sizeable impact on young homebuyers' housing needs. Since the 1970's, about one million low- and moderate-income Americans have bought a home. All of these homes were sold, financed and -- in many cases -- built by private businessmen who have supported housing finance agency programs. Every state and local housing finance agency relies on the private sector -- not the public sector -- to make mortgage revenue bond programs work.

The Tax Reform Act of 1986 placed several restrictions on mortgage revenue bonds. First, all so-called "private purpose" tax-exempt bonds -- including mortgage revenue bonds -- are subject to a statewide volume cap equal to the greater of $50 per capita or $150 million. Second, mortgage revenue bonds must be limited to persons whose income is not greater than 115 percent of the higher of area or state median income. Third, the purchase price of a mortgage revenue bond financed residence cannot exceed 90 percent of the average area purchase price of a residence. Fourth, at least 95 percent of mortgage revenue bond proceeds must be used to provide loans to first-time home buyers.

Mr. Chairman, as you know, the Ways and Means Committee has proposed another set of restrictions to be placed on mortgage revenue bonds, in connection with its agreement to extend the program for two more years. While we heartily endorse the two-year extension, we hope that the Finance Committee will not agree to the restrictions proposed by the Ways and Means Committee, which would only further weaken an already tightly restricted program.

In particular, NAHB objects to the Ways and Means Committee's proposal to require recapture of the mortgage revenue bond subsidy upon the disposition of a home.

Mr. Chairman, the purpose of the program is to give young, first-time, moderate-income homebuyers a stake in the American Dream. Requiring homeowners to pay back the benefit provided through mortgage revenue bonds would serve only to erode the stake and would dampen young American's enthusiasm for homeownership. Thus, we urge you to reject the Ways and Means Committee's recapture proposal.

Low-Income Housing Tax Credit

Mr. Chairman, NAHB believes that the tax credit for low-income housing was one of the few positive aspects of the Tax Reform Act of 1986. This provision at least indicated Congress' recognition of the Tax Code as a proper tool for the provision of low-income housing. Although the final product was far from perfect, the enactment of the credit was evidence of Congress' belief that a tax incentive must be provided to encourage construction, rehabilitation and maintenance of low-income housing.

In a statement we submitted to the Ways and Means Subcommittee on Select Revenue Measures (March 17, 1988), we made several suggestions for improving the tax credit in order to make it a better tool for the production of low-income housing. For example, we suggested that the problem of how the tax credit interacts with the passive activity loss restrictions must thoroughly be re-examined. We, however, realize that substantive problems with the tax credit are issues for another year.

The most important issue regarding the credit this year is that you agree to the Ways and Means Committee proposal to extend the availability of the credit through 1990. Even though the credit does not expire until the end of 1989, its extension this year is urgently needed because of the lead-time necessary in the construction of low-income housing.

Mr. Chairman, this concludes my remarks. I would now be pleased to answer any questions the Committee may have regarding my testimony.

Prepared Statement of

Barry Zigas, President

National Low Income Housing Coalition

on

S. 2238, the Technical Corrections Act of 1988

Mr. Chairman, distinguished members of the Committee, my name is Barry Zigas. I am the President of the National Low Income Housing Coalition. The Coalition is a national, nonpartisan nonprofit organization whose members include low income tenants, organizers, advocates, and public and private producers and managers of low income housing. I appreciate the opportunity to appear before you today to testify on S. 2238, the Technical Corrections Act of 1988.

My remarks today will cover two principal areas: a summary of the housing crisis facing low income people, to highlight the need for the continuation and improvement of the low income housing tax credit, and specific comments on the provisions of the Act which relate to the low income housing tax credit.

The Low Income Housing Crisis

Americans today face an almost unprecedented housing crisis. Millions of Americans cannot find decent housing at any price. This is especially true in rural areas where credit is not available, and where poor families often still live in homes without running water. But it is also true in large cities, suburbs and towns for large families, the disabled, single adults and for many elderly.

Structurally unsound housing remains a problem throughout the country. In 1983, 4.5 million homeowners and 5 million renters lived in housing that did not meet minimum quality standards. The absolute number of low income families living in substandard housing increased by 20 percent from 1 million in 1973 to 1.2 million ten years later. Twenty-six percent of renters with incomes below $5,000 occupied structurally unsound housing, according to a recent study by the Joint Center for Housing at Harvard University.

Housing affordability has also priced millions of housing units out of poor people's reach. In 1970, the nation boasted 14.9 million rental housing units that could be rented at 30 percent of a $5,000 income. The number of renter households with $5,000 per year or less at that time was 8.4 million. But ten years later, the number of affordable units had dropped to only 2 million, while the number of households declined only to 5.5 million.

While the supply of government subsidized housing has increased since such programs first began in 1937, the fact is that the federal Department of Housing and Urban Development (HUD) now provides subsidies to only 4 million households. So while the need for housing among very poor families grew from 1970 to 1983 by leaps and bounds, the federal government has provided in its entire 50-year history only about one-third the number of affordable housing units that have vanished from the inventory through rent increases, demolition and abandonment in only a short ten-year period.

There is a critical and growing need for rehabilitation and new production of affordable, decent housing throughout America.

Yet during the last eight years, federal support for housing assistance has been slashed by over 75 percent. The number of households slated to receive assistance has been cut from nearly 250,000 in FY81 to barely less than 84,000 under the appropriation approved last month in the House. (Under the Senate Appropriations Committee proposal for FY89, less than 80,000 new households would receive assistance.) Very little of the assistance which is being made available can be used to address the problems of substandard housing, inadequate housing, or sheer lack of available housing which plague so many communities.

One symptom of this vanishing federal presence on the housing scene is the virtual disappearance of the large, profit-motivated developer of affordable housing for low income people. As anyone in the development community will freely admit, low income housing has lost its appeal to most of the firms who once specialized in building and developing it. And while the supply of high-priced luxury apartments continues to grow, even to excess in some areas, the supply of affordable rental housing is disappearing.

In addition to the deterioration and rising costs of rental housing, hundreds of thousands of housing units now receiving subsidies through a combination of tax incentives and direct federal subsidies are now in danger of being lost to the affordable low income housing inventory. According to the recent report of the National Low Income Housing Preservation Commission co-chaired by former HUD Secretary Carla A. Hills and former House Banking Committee Chairman Henry S. Reuss, over 500,000 units of housing now receiving these subsidies could be lost over the next ten years because of prepayments of existing mortgages or because of defaults by current owners. One of the reasons highlighted by the Commission and by the National Housing Task Force as a leading reason these properties are endangrered is the changes in tax treatment which were included in the Tax Reform Act of 1986.

The upshot of these grim figures is that Congress must maintain at least the present level of assistance in tax and direct subsidies in order to avert a wide-spread crisis. The National Low Income Housing Coalition has historically supported direct subsidies for low income housing, either directly to tenants or in the form of grants or loans to owners and developers, and opposed less efficient, indirect subsidies through the tax system.

The low income housing tax credit

However, in 1985 and 1986 we worked closely with Sen. Packwood, Sen. Mitchell and others to create the low income housing tax credit. The credit is available on a much more restricted basis than former tax subsidies; it is linked to occupancy by low and very low income persons; it requires continuing availability of the units for poor people; and it requires substantially higher proportions of any property to be devoted to this use in order to qualify any units for the subsidies. We believe that in the current climate continuation of the tax credit is absolutely essential if we are to make any progress in addressing the housing needs of low income people. Moreover, we believe that the credit can and should be improved in minor and major ways in order to more fully realize its potential to attract private investment into housing which is affordable to low income people and maintained for their continuing affordable use over long periods of time.

The tax credit for low income housing was enacted to replace other incentives which were abolished in the 1986 Act. At the time of its initial consideration, we and others who worked with the House and Senate on the credit's creation emphasized that without other subsidies, projects could not meet the credit's strict targeting requirements. We vigorously supported those increased targeting requirements, because we believe that the government should limit subsidies for development to projects which serve a clear national purpose. The development and preservation of low income housing is such a purpose. The low income housing tax credit was designed to stimulate investment in properties that would not be able to compete for capital otherwise.

To paraphrase a popular aphorism, "rumors of the low income housing tax credit's death are greatly exaggerated." Throughout the country hundreds of for-profit and nonprofit developers have taken advantage of the credit's provisions to build and renovate low income housing. The record of the last year has borne out our early predictions. Tax credit projects can be carried out. But they cannot successfully meet the targeting requirements of the program without other subsidies.

These subsidies can come from a variety of sources--federal programs such as the Farmers Home Administration Section 515 loan program, CDBG grants, state and local government assistance programs, and philanthropic contributions. But whatever the source, all of these subsidies serve the same purpose: to close the gap between the costs of producing or rehabilitating rental housing for very low income people and the rents which those households can afford to pay. The Committee must recognize that the development and preservation of affordable housing for very low income people requires large subsidies on a long-term, ongoing basis.

Repealing the 1989 Sunset Date

The most critical problem users of the low income housing tax credit face today is the present sunset date of December 31, 1989. In order to qualify for credits, project sponsors must have their buildings placed in service during the calendar year in which they seek credits. Because of the long lead times involved in development and rehabilitation of housing, sponsors who are not sure they can finish their projects by the end of 1989 will not move forward with badly needed housing projects for low and moderate income people. All credits must be used within the calendar year for which they are allocated; there is no carryover of credit authority permitted under current law.

Unless the credit is extended in 1988, much of this work spent learning will have been wasted. If sponsors cannot be assured that credits will be available for projects which are completed after the end of calendar 1989, then they will not move forward. Because of the time involved in project planning, this means that projects not started by the end of this year will not go ahead. This will dry up the pipeline of affordable housing projects and guarantee poor utilization rates of the remaining 1989 authority.

I urge the Committee to adopt the one-year extension of the credit as proposed in S. 2411, introduced by Sens. Mitchell, Danforth and numerous other members of this Committee. We fully support this extension; it is urgently needed.

S. 2238

S. 2238 contains numerous provisions which relate to the low income housing tax credit. I would like to review several of these in greater detail.

Election of Credit Rate

One amendment would permit sponsors to choose the credit rate which would apply to their property either at the time the unit is placed in service or at the time an allocation from the state agency is received. We strongly support this change. Because the 1986 Act required the credit rate to change over time and be published once a month, project sponsors need to be able to lock in their projected credit rate in order to market the credit to investors. The uncertainty of the present system is unworkable.

Waiver of the 10-Year Placed in Service Rule

There is an urgent need to clarify the provisions under which projects can receive a waiver from the rule prohibiting the acquisition credit for properties last placed in service less than 10 years before acquisition for credit purposes. The legislation should be amended to clarify that if a project is foreclosed by HUD or another public agency, it is automatically cleansed of any taint caused by the 10 year rule. Alternatively, the law could be changed to simply exempt such properties from the rule altogether, which would be an easier and less cumbersome solution. S. 2238 contains some language that is designed to ameliorate this problem. However, it does not go far enough. Although a foreclosure would not count under the proposed amendment for the 10-year rule, HUD projects which end up in foreclosure are most likely to have had at least one change in ownership in the last ten years as attempts were made to salvage the project short of foreclosure. Thus, even though HUD's foreclosure would not count as a placement in service for the 10 year rule, many properties that need the credit to be put back into productive use will not qualify under this narrow rule. The law should make it absolutely clear that such transfers prior to a foreclosure do not come under the coverage of the 10 year rule. A foreclosure should "restart the clock" for the project. This is essential because if properties cannot be transferred out of HUD ownership using the credit, they will languish in the HUD inventory, costing the taxpayers money and jeopardizing the continued maintenance and liveability of the units.

HUD does not have a good track record as a manager of foreclosed properties. Congress should be promoting policies to encourage the recycling of these projects with continued low income use restrictions. Allowing the use of the credit for acquisition purposes, regardless of the transfer history prior to foreclosure is essential to do this.

This section of the law should also be changed to permit a waiver when necessary to help avert a mortgage prepayment and to preserve a property's low income use restrictions. This is very important in the HUD-assisted stock I described earlier in my testimony. Where owners are weighing the possibility of a sale or refinancing which would result in prepayment of the mortgage, the possibility of selling to new owners who would receive full tax credit benefits in return for maintaining the low income use restrictions could make the difference in preserving the housing. The cost of adding this waiver condition would be negligible, while the loss of the housing would be irreplaceable.

S. 2238 would remove clause (iii) which permits a waiver "by reason of other circumstances of financial distress." This is a serious mistake and the clause should be left as is.

The current provisions should also be clarified to permit a waiver in projects for which the mortgage has been assigned or foreclosed by HUD, not simply to prevent an assignment.

I urge the Committee to consider further changes to the ten year rule which would permit a blanket exemption from the rule for any transfer to a nonprofit entity which is acquiring the property for the purpose of preserving its affordable use for low income persons. Similarly, there should be a blanket waiver where a public agency certifies that failure to waive the rule will lead to the involuntary displacement of low income tenants.

Finally, properties which are insured by state and local agencies should be included under all of the provisions relating to HUD-insured housing. There are many thousands of HUD subsidized housing units which were financed by state and local agencies and which are facing the same preservation threat as HUD insured properties. They should not be excluded from the favorable treatment which we are advocating for HUD properties.

Rental Assistance Payments

S. 2238 would change the 1986 Act to clarify that rental assistance payments of any kind, no matter what their source, do not count as federal subsidies for purposes of determining the appropriate credit amount. We strongly support this important change.

Rehab by Current Owners

I urge the Committee to address a particular problem which has arisen in the administration of the credit for rehabilitation expenses undertaken by current owners. When the credit was first developed by the Senate, it clearly was meant to include assistance to current owners of qualifying properties who undertook rehabilitation and agreed to meet the requirements for income and rent targeting. Yet because of a conflict with another section of the law, it is not possible for rehabilitation credits to be claimed without a change in ownership. This needlessly forces owners of properties in need of rehabilitation to preserve affordable housing opportunities for low income people to consider selling the property rather than maintaining it by expanding the current partnership to bring in new investors to take advantage of the credit. Other members of our Coalition have been working with Sen. Mitchell on this problem; I hope the Committee will be able to solve this problem.

LONG-TERM POLICY ISSUES

S. 2238 addresses the immediate technical corrections which are needed to facilitate the use of the low income housing tax credit. Its adoption, with the changes we have recommended, is critical. Many of these provisions have been awaiting enactment since 1986, when there was general agreement on them. This Congress must pass these amendments before the end of the 100th Congress.

There are, however, other issues relating to the tax credit that the Committee should consider as early as possible in order to perfect its usefulness. Sens. Mitchell and Danforth have requested the assistance of a broadly-based group of experts on housing and the tax credit to draw up recommendations for their consideration; I have the privilege of serving on this task force. I applaud their initiative and dedication to making the tax credits work more effectively.

The following suggestions outline areas in which we hope the Task Force and Committee will make changes to increase the credit's usefulness.

Refundability

The Committee should seriously consider making the credit refundable. Many nonprofit organizations are reluctant to take advantage of the tax credit because they cannot use it without giving up ownership of the property. Refundability was part of our original proposal to the Congress in 1985. It would offer the possibility of financing housing which would start out and end up in the nonprofit or social housing sector, free of the expiring use concerns which are now preoccupying us.

The truth is that the tax credit is sowing the seeds of another prepayment disaster in 15 years. Once the compliance period for the credit has expired, conflicts will inevitably arise between the profit motivated owners of the property, who acquired their interest principally for tax benefits in the first place, and residents and/or nonprofit sponsors, who will want to maintain the low income use indefinitely. This need not be so. I urge the Committee to amend the credit program to avoid this result.

Disposition After Compliance Period

The tax credits require that use restrictions remain in place for 15 years. While this provides substantially greater low income use than previous tax subsidies, there is no question that in 15 years many properties will be facing the same catastrophe now confronting the Section 236 and 221(d)(3) stock: conversion to non-low income use because of sale or refinancing at the end of the compliance period.

Congress should act now and consider ways in which to insure that tax credit housing can be transferred into social or nonprofit ownership at the end of the compliance period through agreements reached now between sponsors and investors. If sponsors are forced to wait until the end of the period to negotiate such transfers, they may be overtaken by economic and market trends which overwhelm whatever good intentions investors had in 1988. The law should explicitly bless front-end agreements in which investors' interests are donated to a nonprofit sponsor at the end of the compliance period. This is a poor second to making the credit refundable, and eliminating this entire transaction, but it would be better than the current law. The Committee should also change current law to enable corporations to participate in pooled income trusts which invest in low income tax credit-eligible properties. This device serves the long-term preservation goal by permitting the investors to donate their interests in the property at the front end of the deal. There are tax-credit investments being structured for individuals using this device. Corporations also should be allowed to participate, since they are the largest single investor group in the credits.

Limitations Where Other Subsidies are Used

One of the most crippling provisions of the current law is the restriction against using the full rehab/development credit where other federal subsidies are being used. This limitation is senseless in most circumstances. The fact is that tax credit properties cannot be made affordable to the intended income group without additional subsidies. The current language encourages sponsors and developers to engage in imaginative stratagems to hide subsidies, or allocate them to acquisition, where the penalty does not apply, or to rely entirely on Section 8 subsidies, which are exempt from the general prohibition, in order to maintain affordability.

This restriction was placed in the law to hinder so-called "double dipping" in federal subsidy funds by sponsors and developers. It was founded on a belief that huge profits could be made through the application of the tax credit to projects already receiving enough assistance to be economically viable. This restriction is a reaction to a milieu which no longer exists, and did not exist at the time the 1986 Act was adopted. If there are instances where current direct federal subsidy programs make the full development credit too rich, then the law should address these exceptions. They are not the rule. Moreover, the current law already empowers states to allocate less than the full credit amount. This authority can be used to adjust the value of the credit to provide owners and investors with fair but reasonable rates of return on their investments.

Unlike previous tax incentives, tax credits are only available for units which actually serve low and very low income people, with rents which are strictly limited. The tax benefits are targeted for a specific purpose. By so restricting the credits, it becomes essential to have unfettered access to other subsidies--regardless of their source--in order to meet the credit's requirements.

HOUSING ASSISTANCE EQUITY

There have been many other suggestions for improvements in the credit which I urge you to consider. I would like to close by making one final point.

Since 1981, direct federal commitments for low income housing have plummeted by over 75 percent. Commitments to provide assistance to new families have been reduced from over 200,000 in fiscal 1981 to less than 80,000 in fiscal year 1988. In FY 89, outlays for HUD-assisted housing will rise to their highest level in history: a mere $12 billion.

At the same time, this Committee has presided over the continuing expansion of the most lucrative and poorly targeted housing subsidy system ever. Over $40 billion in untargeted tax subsidies will be spent this year to subsidize high income homeowners. I recently analyzed the distribution of these benefits among different income groups, using the Joint Committee on Taxation's income and tax liability estimates for FY88. The findings are quite interesting.

A total of 29.6 million filers will claim the homeowner mortgage interest deduction in FY88. Together they will receive $27.7 billion in tax subsidies. Of this total, only 35.5 percent will have incomes above $50,000. Yet they will receive 66 percent of the subsidies. Only 13 percent of those claiming the deduction will have incomes over $75,000 per year, but these filers will receive 35 percent of the dollar value of the mortgage interest deduction subsidies.

These figures are disturbing enough. They mean that 4 million filers with incomes above $75,000 will receive nearly $10 billion in housing subsidies from mortgage interest deductions, and another nearly $3 billion from property tax subsidies, or more than all of HUD's subsidies for the total universe of 4 million low income households now receiving HUD assistance.

When you compare these very high income filers with the total filing population--not just those claiming the deductions--the proportions are even more unbalanced. While only 11 percent of all filers will have incomes in excess of $50,000, they will receive 66 percent of the value of the homeowner deductions. Those filers with incomes above $75,000 make up only 3.7 percent of all filers, yet they will receive 35 percent of the homeowner deduction benefits.

I highlight these facts because some members and staff have vigorously opposed the low income housing tax credit because of its cost. Yet the same publication prepared by the Joint Committee on Taxation estimates that total revenue losses from the use of the low income housing tax credit will equal $300 million in FY88, $600 million in FY89, and $900 million in FY90. Every one of these subsidy dollars will be spent to stimulate investments in properties which must by law provide housing for people with incomes below 60 percent of the area median income, at rents which cannot exceed 30 percent of that ceiling income level.

I submit to you that in comparison with the need, and in comparison with the extraordinary and inequitable tax subsidies this Committee countenances for homeowners with the highest incomes in the country, continuation of the low income housing tax credit is a modest contribution to assuring that we meet the goal of a decent, affordable home for every American.

Thank you for the opportunity to appear before you today; I will be happy to answer any questions you may have.

COMMUNICATIONS

ACKERLEY COMMUNICATIONS, INC.

July 19, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Bldg.
Washington, DC 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization--as they may be required under state and federal law. Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, are staggering.

The rules are incredibly complex--yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

U.S. Senate Committee on Finance
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July 19, 1988

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

- * Repealing Section 89;
- * Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- * Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Keith W. Ritzmann
Corporate Controller

KWR/ju
Enc.

cc: Senator Brock Adams
Senator Daniel Evans
Congressman Mike Lowry

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July 27, 1988

Laura Wilcox, Hearing Administrator
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Washington, D.C. 20510

Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
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Washington, D.C. 20510

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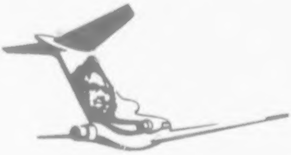

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Sincerely,

Charles S. Loughran Tressa S. Clark

Charles S. Loughran	Tressa S. Clark
Vice President	Manager
Human Resources	Employee Benefits

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STATEMENT OF
ALDRICH, EASTMAN & WALTCH, INC.
THE BOSTON COMPANY REAL ESTATE COUNSEL, INC.
COPLEY REAL ESTATE ADVISORS, INC.
PROPERTY CAPITAL ASSOCIATES

On June 30, 1988, the Finance Committee requested comments on the Technical Corrections Act of 1988 (S. 2238). We are pleased to have the opportunity to respond to this request, and in particular to the proposed amendments relating to section 514(c)(9) of the Internal Revenue Code of 1986, as amended (the "Code").

INTRODUCTION

We are four real estate investment management firms which advise major taxable and tax-exempt investors, such as pension funds and educational endowments, and manage their real estate investments. Our clients are long-term investors who view real estate as an integral part of a prudently diversified investment portfolio, providing them with stable current returns and opportunities for substantial appreciation. We have been responsible for acquiring, directly and indirectly, several billion dollars in office buildings, retail and industrial projects, and multi-family residential properties, on behalf of our clients as portfolio investments. A large portion of these investments in real property are made through joint ventures involving both tax-exempt and taxable partners. Joint ventures are preferable because tax-exempt organizations are passive investors without the personnel or expertise to engage in real estate management or development activities, whereas most taxable partners are in the business of real estate development or management. They offer pension funds and other tax-exempt investors the opportunity to gain from the expertise of professional real estate firms, who typically will make investment opportunities available only if they are able to participate in the transaction. Moreover, joint ventures allow a tax-exempt investor to prudently diversify its portfolio. Finally, many of these investments are partially financed with third party debt, thereby increasing the potential investment return.

Sections 512(b)(4) and 514 of the Code provide that income from debt financed property generally will be considered unrelated business taxable income ("UBTI"). Congress initially added section 514(c)(9) to the Code in 1980 for the specific purpose of allowing retirement trusts to invest in debt-financed real estate without generating UBTI. Beginning in 1984, each tax act has significantly changed this section -- swinging like a pendulum between the exclusive goal of restricting the potential tax avoidance which might result from the shifting of tax losses to taxable partners and income to tax-exempt partners and tempering this goal with commercial realities. As a result of the Revenue Act of 1987 (the "1987 Act"), however, it is virtually impossible to satisfy the UBTI exception for debt-financed real estate held by joint ventures. Moreover, many transactions that had been months in the planning were abandoned following the 1987 Act and its restrictive effective date.

Although unintended, the cumulative effect of these changes has been a de facto repeal of this exception from UBTI, despite continued Congressional support of the ability of pension funds and endowments to engage in such transactions without incurring UBTI. Recent hearings regarding the investments of pension funds reflect Congressional concern that today's workers retire with a secure source of adequate retirement income. Nonetheless, these recent amendments to section 514(c)(9) severely undermine this policy by restricting the availability of attractive, secure, income-producing investments.

Section 514(c)(9) fails to achieve its original purpose and conflicts with other important government policies because it is now internally inconsistent. The Treasury, taxpayers, and tax-exempt investors are all dissatisfied with the current statute. Section 204(g) of S. 2238 attempts to correct the internal inconsistencies by delegating additional regulatory authority to the Treasury. To the same end, H.R. 4333, as reported by the Ways and Means Committee, includes an additional change to Section 514(c)(9)(E) to eliminate redundancy. We believe the former to be insufficient and the latter to be clearly ineffective. Internal hemorrhaging cannot be stopped with band-aids; corrective surgery is needed. Accordingly, we propose a new section 514(c)(9)(E) that would allow section 514(c)(9) to accomplish its original purpose and at the same time would erect adequate safeguards against tax avoidance.

HISTORY OF THE DEBT-FINANCED INCOME RULES AND THE REAL PROPERTY EXCEPTION

The original UBTI statute, enacted in 1950, generally excluded from its definition of UBTI traditional forms of passive investments, but included net income from debt-financed property leased for more than five years. In 1969, Congress expanded the scope of section 514 to include in UBTI net income from all debt-financed property. In 1980, Congress introduced an exception to section 514 for debt-financed real estate held by qualified retirement plans, albeit with a number of requirements to prevent tax avoidance transactions.

1984 Act. The Deficit Reduction Act of 1984 extended the qualified plan exception of section 514(c)(9) to real property held by certain educational institutions and certain affiliated support groups. The price for expanding the class of eligible tax-exempt entities was the imposition of new restrictions applicable to partnerships consisting of both "qualified organizations" (qualified plans and the educational institutions) and "non-qualified organizations" (including taxable entities and qualified organizations having any UBTI). Section 514(c)(9)(B)(vi). Allocations of such partnerships were required to be "qualified allocations", i.e., shares of income, gain, loss, deduction and credit could not change over the term of the partnership, and were required to have substantial economic effect.

1986 Act. The Tax Reform Act of 1986 again changed section 514(c)(9)(B)(vi) in two subtle, but important ways. First, the requirement that allocations be qualified allocations was liberalized to a "principal purpose of tax avoidance" test because so many real property investments are structured as joint ventures and the qualified allocation standard is inconsistent with the economics of most joint venture transactions involving both qualified and non-qualified organizations. Second, section 501(c)(25) collective investment entities were added to the Code and were included as "qualified organizations." Because all section 501(c)(3) organizations are eligible to invest in a section 501(c)(25) entity, a foundation or charity could receive the benefits of the real property exception that it would not enjoy had it invested directly in the property. (Section 116 of S. 2238 would eliminate this benefit retroactively.)

An equally significant change made by the 1986 Act was the radical reduction in the value of tax benefits pursuant to that legislation. The adoption of the passive loss rules, the extension of the at-risk rules to real estate, the required capitalization of construction period interest, the reduction in rates, and the fact that most real property will have to be depreciated over a 40-year useful life, makes the tax benefits available in these ventures of relatively small value. Moreover, because of the passive loss rules, these benefits are only of use to certain corporations and those developers who happen to have substantial cash flow from other investments.

1987 Act. Early in 1987 some tax writers became concerned that the 1986 amendment to section 514(c)(9) went too far. Despite the fact that no abusive transactions otherwise permitted under prior law were presented to justify this belief, H.R. 3545, as passed by the House restored the qualified allocation standard. Although the Senate bill contained no similar provision, the conference agreement reinstated the qualified allocation standard and added, as an alternative, the new "fractions" test of section 514(c)(9)(E). An allocation satisfies the "fractions" test of new section 514(c)(9)(E) if: (1) allocations of overall partnership loss to a "non-qualified" partner may not exceed its smallest share of overall partnership income in any tax year; (ii) each qualified organization's share of income cannot exceed its smallest share of overall partnership loss for any tax year; and (iii) every allocation must have substantial economic effect.

1988 Technical Corrections. Section 204(g) of S. 2238 would amend section 514(c)(9)(E) to give Treasury additional regulatory authority to resolve some of the inconsistencies in the 1987 statutory tests. Section 204(g), however, is insufficient to make the current statute workable, in part because the authority it purports to grant to Treasury is undercut by the technical explanation which creates, rather than resolves, open issues by creating priorities between sections 514 and 704(b) of the Code.

H.R. 4333, the TCA reported by the Ways and Means Committee would repeal the limitation on losses to a non-qualified organization as a redundant provision. Since the income limitation on qualified organizations serves the same function, repealing the loss limitation fails to solve most of the problems inherent in the fractions test.

PROBLEMS WITH CURRENT LAW AND PROPOSED TECHNICAL CORRECTIONS.

Section 514(c)(9) currently imposes two alternative tests for allocations between qualified and nonqualified organizations -- the qualified allocations test and the fractions test. Neither test is satisfactory in operation.

The qualified allocations test presents a number of obstacles. First, it does not permit preferred returns to the qualified organization, who typically contributes most of the capital to the transaction; even the level of permitted guaranteed payments to a qualified organization is unclear. Second, it does not permit a qualified organization to have limited liability without incurring UBTI; allocations cannot remain unchanged and satisfy the substantial economic effect test unless the limited partner has a full deficit restoration obligation. Third, it does not take into account differing capital contributions by the partners without imposing deficit restoration obligations on those partners with disproportionately small contributions. In the rare situation that a developer (which normally has the small contribution) is willing and able to undertake a deficit restoration, the impact is to accelerate deductions to the taxable partner from the tax-exempt entity.

As a result of these problems, leveraged investment in most real property by most qualified organizations largely came to a halt between the enactment of the 1984 and

1986 Acts. The limited liability and unequal capital contribution problems, in particular, make the "qualified allocation" test virtually useless in structuring transactions.

The fractions test also presents several problems. First, the statute punishes the wrong party; if the non-qualified organization could have allocations of loss or income not in compliance with the statute, the qualified organization suffers. Second, the statute does not permit qualified organizations to protect their assets by investing as limited partners; once a qualified organization's capital has been exhausted, it cannot satisfy both the fractions test and the regulations under section 704(b)(2) if it wants to limit its liability and protect its other assets. Under the current statute, qualified organizations that are limited partners will have UBTI unless they agree to unlimited liability. Yet, pension funds prefer to invest as limited partners precisely to limit their exposure to such risks. Thus, passive investing designed to protect a pension fund's corpus would subject the fund to UBTI whereas a fund that placed all of its assets at risk (by means of an unlimited deficit restoration obligation) would not be taxed.

Third, the statute disqualifies allocations if there is any theoretical possibility that the test might not be satisfied at any time in the future, no matter how unlikely the event. Fourth, the regulations provide that certain allocations (such as nonrecourse deductions) cannot have substantial economic effect but nonetheless may satisfy section 704(b)(2); the fractions test, on its face, does not appear to permit such allocations, notwithstanding the fact that loans secured by commercial real property generally are nonrecourse. Finally, the test is all-or-nothing -- if each requirement might not be satisfied due to some unforeseeable circumstance or inadvertent error, the qualified organization will be subject to tax and its beneficiaries unfairly punished.

A simple example illustrates some of these problems. Assume that a taxable developer (T) invests $1x as general partner, a qualified plan (P) and a college endowment (C) each invest $9.5x as the limited partners, and the partnership borrows $20x on a nonrecourse basis to acquire a building depreciated over 40 years. Cash distributions are made equally among T, C and P after reasonable preferred returns are paid. Income is allocated first to reflect preferred returns and thereafter pro rata among the partners. Neither P nor C is required to contribute additional capital. Losses would be allocated in accordance with the partners' share of profits (in excess of priority distributions), subject to the restrictions on losses contained in the section 704(b) regulations. The partnership's allocations otherwise satisfy the section 704(b) regulations.

Under present law the results are as follows:[*/]

(a) Since P and C are not required to restore any capital account deficits, it is possible that their smallest share of losses could be zero after their capital accounts are exhausted -- no matter how unlikely this is to occur. Thus, P and C's largest permissible allocation of income under the statute would be zero. That obviously is not the desired result. Allocations of loss after the qualified organizations' capital accounts are exhausted generally should be disregarded in determining minimum overall shares of loss.

(b) The partnership's allocations cannot have substantial economic effect because deductions attributable to nonrecourse debt cannot have substantial economic effect. Treas. Reg. § 1.704-1(b)(4)(iv)(a). It must be made clear that allocations which are deemed to be in accordance with the partners' interests in the partnership under the section 704(b) regulations will be treated as having substantial economic effect.

(c) If the combination of unexpected distributions, loss allocations and layers of nonrecourse and recourse indebtedness unexpectedly cause loss sharing ratios to be slightly different than anticipated, P or C could be treated as having UBTI even though no tax avoidance was intended or, in fact, occurred. A rule similar to section 7704(e), allowing the parties to retroactively cure inadvertent or de minimus violations, should be added to protect against such problems.

(d) If, on audit, some portion of the profit or loss allocations are reallocated, P and C could be subject to UBTI. The parties should retroactively be able to cure any violation caused by audit adjustment.

Another problem could arise in a tiered partnership arrangement. If the limited partner is itself a partnership composed of one or more taxable persons and qualified organizations, and that partnership itself satisfies one of the section 514(c)(9)(B)(vi) tests, there is no way to determine whether all the partnerships satisfy section 514(c)(9)(B)(vi). The preferred rule would be that each partnership's allocations should be examined separately, with appropriate conventions provided in regulations to fulfill Congressional intent. Guidance is critical so that the parties do not need to be concerned about their partners' internal arrangements.

[*/] This transaction would not have caused P to have UBTI between the enactment of the 1980 legislation and October 13, 1987, although this result would not have been evident between the effective date of the 1984 legislation and the enactment of the 1986 legislation (because the technical correction was retroactive). C would not have been able to invest in such a transaction with no expectation of deriving UBTI except during the period between the enactment of the 1986 legislation and October 13, 1987. Despite the fact that this transaction is not tax motivated, it does not satisfy either the qualified allocation or the "fractions" test of section 514(c)(9)(E).

Finally, the definition of a qualified organization needs to be clarified. A governmental unit or plan (which is tax-exempt) is not currently within the definition of a qualified organization. Such entity's participation in a partnership should not disqualify allocations for a qualified organization if they invest on the same terms. Qualified organizations are already disadvantaged by virtue of the fact that they can no longer invest on the same terms as taxable investors.

PROPOSED CHANGES

1. Amendments to Section 514(c)(9). Admittedly, some, but not all, of the problems in section 514(c)(9) could be resolved by Treasury when it issues regulations. However, given Treasury's failure to resolve many of the issues for which it already clearly has regulatory authority under last year's legislation, and given the burden already placed on Treasury to develop regulations for hundreds of other projects, meaningful guidance could take years.

In light of the serious shortcomings of the statutory amendment that the staff is now considering, we propose an alternative solution to the problems in section 514(c)(9)(E). (See Appendix A). In brief, under our proposal, a partnership's allocations of net loss to a "non-qualified" organization partner are limited to such partner's minimum share of profits. Any disallowed losses may be carried forward to subsequent years in which either (i) the partnership has income, (ii) such partner is allocated losses in an amount less than its loss limitation, or (iii) such partner disposes of its interest in the partnership. We believe that this proposal effectively prevents the shifting of income and losses between the taxable and tax-exempt sectors by eliminating the tax benefit of such a shift. It permits our clients to negotiate the best commercial terms for their transactions without regard to the tax consequences. It has the further virtue of eliminating the possibility that an inadvertent or de minimus violation will cause all of the qualified organization's income from the investment to be treated as UBTI from the outset.

2. Public Pension Funds. Clarification is necessary regarding an unnecessarily clouded issue in the law. Public pension funds do not need to obtain determinations that they are exempt under section 401(a) of the Code. Accordingly, some have questioned, at least in theory, whether they are qualified organizations for purposes of section 514(c)(9), or are otherwise exempt from tax under section 115 or on constitutional grounds. The clarification is important because it affects the UBTI status of the qualified organizations (qualified plans and endowments), and not the status of the governmental plans and entities. We believe that this issue should be dealt with either by explicitly including governmental plans and entities (as defined in section 501(c)(25)(C)(ii) and (iii)) in the list of qualified organizations under section 514(c)(9)(C), or by providing that they will not be treated as not being qualified organizations for purposes of section 514(c)(9)(B)(vi).

CONCLUSION

Due to the series of amendments designed to prevent potential tax avoidance, section 514(c)(9) no longer achieves its intended purpose. We believe that the proposed changes in S. 2238 and H.R. 4333, the TCA as reported by the House Ways and Means Committee, are insufficient to remedy the statute's problems. Therefore, we urge you to consider our proposed changes to section 514(c)(9). They are consistent with Congressional intent regarding real estate investment by tax-exempt organizations and they erect adequate safeguards to prevent tax avoidance by means of shifting partnership losses.

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE
ON THE PROVISIONS OF
S. 2238, THE TECHNICAL CORRECTIONS ACT OF 1988
JULY 25, 1988

This statement is submitted on behalf of the American Council of Life Insurance, the industry's major trade association representing over 600 life insurance companies. Following the Committee's desires that statements relate to provisions that have not been the subject of prior hearings, we limit our comments to three areas. We note that the issues raised by sales of single premium life insurance were addressed by Mr. Richard Schweiker for ACLI at hearings held by the Finance Committee's Subcommittee on Taxation and Debt Management on March 25, 1988. Moreover, ACLI covered a number of the current technical corrections issues in a statement filed with your Committee last year, including the transition rule for capital gains on market discount bonds and the treatment of structured settlement annuities under the AMT.

We wish to address the following:

(1) AFR Reserve Provision. Section 10241 of the Omnibus Budget Reconciliation Act of 1987 prescribed that the interest rate to be applied in determining the amount of life insurance reserves for any contract is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. Attachment A sets forth several technical amendments which are needed to make this new provision workable.

(2) Limits on Mortality Charges and Other Expenses. The Ways and Means Committee provisions added to H.R. 4333 to impose mortality and expense charge limits on life insurance policies should be rejected. Attachment B discusses this provision in detail.

(3) Miscellaneous minor matters involving qualified pension and welfare plans. These items are discussed in Attachment C.

Should our comments herein raise any questions, please contact William Gibb, Chief Counsel for Taxes and Pensions. He may be reached at 624-2110.

ATTACHMENT A

April 26, 1988

REVISED

PROPOSED TECHNICAL CHANGES TO THE AFR RESERVE PROVISION ADOPTED IN 1987

1987 Provision

A key element in the computation of life insurance reserves is the interest rate assumed. This is the rate at which future obligations of the company are discounted in computing the reserves. Assets of the company in support of these reserves must earn interest over the life of the contracts at a rate at least equal to the reserve rate to ensure that funds set aside through the reserving process are adequate to satisfy the liabilities assumed.

Prior to the Revenue Act of 1987, the prevailing state prescribed assumed interest rate for a calendar year was used in determining tax reserves for life insurance and annuity contracts issued in that year. In this regard, the state prescribed rates vary by contract type and take into account various factors including the period for which benefits are guaranteed.

The Revenue Act of 1987 significantly altered the reserve calculation in many cases by requiring that the applicable mid term federal interest rate (AFR) be used in the reserve calculation if that rate is higher than the prevailing State interest rate.

Generally, the interest rate used in the reserve calculation for a contract is established as of the date the contract is issued and is used in computing reserves for as long as the contract stays in force. However, a provision was included in the 1987 Act allowing a company a one-time election to update the AFR every five years a contract is in force for purposes of computing reserves for that contract for future years. It should be stressed that this election will practically never be made since it requires pure speculation about future interest rate levels in what has been a rapidly fluctuating interest rate environment.

Proposed Technical Amendments

Several technical amendments to the new AFR provision are necessary to avoid imposing unnecessarily heavy compliance burdens on insurance companies, to prevent unduly harsh results in extraordinary interest rate swings, and to correct certain omissions.

1. Interest Rate Cap. The AFR could, in a volatile interest environment, rise to a high rate which has little or no relevance to a rate which can be realistically assumed under a long-term contract, particularly with premium monies coming in over a period of years. As indicated, the 5-year election provision does not represent a practical solution. Thus, a cap should be imposed on how far the mandated federal interest rate can deviate from the prevailing state assumed interest rate.* A cap equal to the prevailing state assumed interest rate plus 3 percentage points would, under our calculations, have no practical effect on the reserve interest rate for the next five years, assuming interest rates are at the level estimated by CBO.** Thus, adoption of a cap at this level should not be considered to produce a revenue loss for budget estimating purposes.

2. Annuity Calculation. The AFR (when fully implemented) will be based on the average of federal mid-term rates during the five-year period ending before the beginning of the calendar year for which the determination is made. State prevailing interest rates for certain annuities are very closely attuned

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* The cap should also apply to those accident and health insurance policies which are subject to the life insurance reserve rules (see section 846(f)(6)) and, in this situation the cap should be applied against the prevailing state assumed interest rate for a whole life insurance contract (see section 807(d)(4)(D) as in effect prior to the 1987 Act).

** The only type of contracts that could possibly be benefited are certain annuity contracts with interest rates guaranteed for more than 20 years. Virtually no contracts of this type are sold today.

to current money rates since such current rates are used by the company in constructing its guarantees. Specifically, the state prevailing interest rates for these annuities are based on on a 12-month average ending on June 30 of the calendar year for which reserves are computed. The AFR for these annuities should also be based on an average over the identical 12-month period. This 12-month average AFR would be applicable only to those annuities where the "Reference Interest Rate" used in calculating the state prevailing rate is never based on a period longer than twelve months.

3. Tolerance. In contrast to the state prevailing interest rates for most types of contracts, the AFR will change each year. Groupings of different issue years will, thus, no longer be possible in the process of computing a company's reserves since a unique set of reserve factors will apply for each year of issue. As a result, the company will be required to compute, store, and maintain separate factor files and go through the onerous process of applying those factors issue year by issue year. The added complexity will multiply as more issue years fall under the new AFR rules.

   To mitigate this problem, a tolerance should be provided (except for annuities discussed above) under which a new AFR would have to be used only when it is 50 basis points higher or lower than the currently applicable AFR. For example, the AFR for 1988 is 7.77%. Under this proposal, that AFR would remain effective (except for annuity contracts) for new issues until a year when the AFR is 8.27% or higher or 7.27% or lower.

   The concept of a tolerance is used by the states in computing the prevailing state assumed interest rates. In addition, the state formula uses a rounding rule so that fractions of rates are to the nearest 1/4%. Rounding should also be allowed in computing the AFR.

4. Drafting Omissions. Sections 811(d) and 812(b)(2) of the Internal Revenue Code need corrective amendments to carry out the intent of the new AFR provision. A detailed explanation is attached.

ACLI Contacts:

Richard V. Minck -- 624-2100
William T. Gibb -- 624-2110

ATTACHMENT B

July 22, 1988

PROPOSED CAP ON MORTALITY AND EXPENSE CHARGES

House Bill:

The Internal Revenue Code definition of life insurance provides limitations on the amounts that can be paid or accumulated under a life insurance contract. Under the House Bill, for all life insurance contracts, the mortality charges that may be taken into account in computing the definition amounts could not exceed the mortality charges required to be used in determining Federal income tax reserves for the contract. Moreover, the expense charges (which include an allowance for profits) " would be required to be reasonable based on the experience of the company and other insurance companies with respect to similar life insurance contracts." The provision generally would be effective for all life insurance contracts issued on or after July 13, 1988.

Present law does not apply special federally imposed limitations but looks to the mortality and expense charges specified (guaranteed) in the contract.

ACLI Position

The ACLI opposes this provision for the following reasons:

- It reaches far beyond the single premium issue.
- It imposes Federal price regulation of life insurance
- It introduces a level of uncertainty that could result in retroactive taxing of the inside build-up of entire blocks of policies.

Reasons for Position

1. Provision Reaches Far Beyond Single Premium Issue. The cap on mortality and expense charges in the House Bill applies to all life insurance and goes far beyond issues raised by single premium policies. Rather, it imposes unwarranted Federal price regulation of life insurance and opens up the possibility of retroactive taxation of inside build-up for large numbers of policyholders. It was not adopted by the Ways and Means Committee as part of the single premium provision in its bill; instead, it was added at the end of the Committee's deliberations in the Part 6 Miscellaneous Provisions section. It should be rejected by the Senate.

2. Federal Rate Regulation. The House provision effectively regulates the premiums that can be charged for a life insurance policy. This is because if the company charges a higher premium than permitted under the Internal Revenue Code definition of life insurance, the inside build-up will be taxed currently.

No one has proposed or defended the Federal regulation of the price of life insurance, and introducing it through the tax law is wholly unwarranted.

The staff of the Joint Committee on Taxation clearly recognizes that the House provision constitutes such price regulation. The staff noted in the pamphlet it prepared for the single premium hearings that:

> "If the mortality charges used in determining the statutory reserve for a contract and the limitation on expense charges are required for purposes of applying the cash value accumulation test and the guideline premium requirements, the premium that could be charged for any life insurance contract would be statutorily capped." (Footnote 14, page 33 of JCS-6-88)

Moreover, attempts to regulate life insurance premiums are completely incompatible with the facts of the marketplace. Companies may have different costs for a wide variety of reasons; e.g., they are located in a high wage as compared to lower wage area of the country; they use different marketing arrangements, for example, direct mail as compared to an agency force, etc.

In addition, rate regulation of this sort puts the IRS in the position of regulating the allowance for profit that may be built into the price of a policy.

3. Retroactive Tax on Inside Build-Up. The proposed standards are not, and cannot be precisely defined. Because there can be no certainty, entire blocks of policies could be retroactively disqualified in an IRS audit taking place long after the policies were sold. In such a situation, the inside build-up could be taxable on a retroactive basis for the many policyholders involved. This is an unfair result for policyholders who have entered into a long term arrangement.

For example, the proposed cap on allowable expense charges is based on " the experience of the company and other insurance companies with respect to similar life insurance contracts." This is a very uncertain standard that depends on information and interpretations which are well beyond any individual company's capacity to obtain and make. Moreover, it would also be generally difficult for the IRS to make their determination. Nevertheless, if the initial determination by the company in setting its premiums is subsequently challenged by the IRS, the inside build-up could become taxable under the severe "cliff" effect of the proposed rule.

By treating the "other appropriate rate" (e.g., the cash value interest rate or the statement reserve interest rate where cash values or statement reserves are being held as tax reserves) as the prevailing state rate, the company would be required to use the AFR, if higher, in computing policy interest under Section 812(b)(2). The intent of current law is to allow the actual interest rate used for accumulating reserves (i.e., other appropriate rate), when different from the prevailing rate, to be used in determining required interest. If not corrected, the result under the new provision would be required policy interest computed by multiplying the AFR times reserves based on rates other than the AFR. A technical correction should be made.

ATTACHMENT C

Miscellaneous Qualified Plan Matters

ACLI is working with Joint Committee staff with regard to three narrowly focused issues:

(1) Under long-standing tax rules, the cost of life insurance protection under a qualified plan is currently taxable to the participants. We believe a technical correction is needed to clarify that such taxable amounts are not considered distributions subject to the additional 10% tax on early distributions. Without an exception from the early distribution tax, many employers will be forced to eliminate the important death benefit coverage currently provided to their employees.

(2) Further modification of the exception to the excise tax on the undistributed income of a regulated investment company (RIC) contained in Section 106(1)(6) of S. 2238 is needed. Under the exception, the excise tax will not apply to any RIC owned predominantly by specified tax-exempt entities, including segregated asset accounts of insurance companies held in connection with variable contracts. Shares attributable to an investment of less than $250,000 made in connection with the organization of a RIC (seed money) will not prevent the RIC from qualifying for this exception. The $250,000 seed money exception is unrealistically low and would make the exception to the excise tax of no value to most insurers.

(3) Finally, H.R. 4333 contains a provision that would make it clear that qualified plan participants are not subject to gift tax merely because they retire with a joint and survivor annuity payable to their spouse. Potential gift tax liability in this instance was an unintended result of the Tax Reform Act of 1986 and we urge that the same provision be included in the bill adopted by this Committee so that this oversight is corrected.

04/26/88

Attachment A

Technical Amendment -- Section 811(d)

Section 811(d) of current law requires that if interest in excess of the state prevailing rate is guaranteed beyond the end of the taxable year on which reserves are being computed, such excess may not be taken into account beyond the end of the taxable year in making the computation. The new AFR provision, while requiring use of the higher of the prevailing state rates or the AFR in making reserve computations, does not include any change in Section 811(d). Hence, even though reserve computations are made using the higher AFR, the limitation on interest guarantees beyond the end of the taxable year is still based on the state prevailing rates. If uncorrected, this could result in not allowing reserve deductions for future guaranteed benefits based on rates in excess of the state prevailing rate even though the higher AFR rate would be required for computing their present value. This is clearly inconsistent and is an apparent oversight. We recommend that an appropriate change be made.

Technical Amendment -- Section 812(b)(2)

Section 812(b)(2) of current law defines required policy interest for the purpose of determining policyholder share of net investment income. The 1987 Act AFR provision changes this definition (subsection (b)(2)(B) of Section 10241) by striking out "at the prevailing state assumed rate or, where such rate is not used, another appropriate rate" and inserts in lieu thereof "at the greater of the prevailing state assumed rate or the applicable federal interest rate". The Act provides further than when the prevailing state assumed rate is not used another appropriate rate shall be treated as the prevailing state rate.

AMERICAN NATIONAL BANK
AND TRUST COMPANY

TRUST DIVISION

July 11, 1988

The Honorable Lloyd Bentsen, Chairman
Senate Finance Committee
219 Senate Building
Washington, DC 20510-6000

Re: Common Trust Funds - Conversion from a Fiscal Tax Year to a Calendar Tax Year As Proposed by the Technical Corrections Bill of 1988 (H.R. 4333/S. 2238)

Dear Honorable Bentsen:

We wish to solicit your support in changing a problematic provision in the Technical Corrections Bill of 1988 (H.R. 4333 and S. 2238). This provision concerns the issue of changing the tax year of all common trust funds to a calendar year-end. The effective date in the bill is for tax years after December 31, 1986.

This retroactive change will require all Bank Trust Departments to file amended returns for literally thousands of trust accounts. Not only will trust accounts be affected, but also all beneficiaries who receive income from the trust accounts will have to amend their personal income tax returns as well. The need to file hundreds of thousands of amended returns because of a retroactive law change seems like an unnecessary burden on the taxpayers, as well as on the Internal Revenue Service.

Because of this, we are asking for your commitment to support a change in this provision to make it effective in the tax year in which the Technical Corrections Bill is passed rather than retroactive to a previous tax year.

In addition, we encourage your support for a November fiscal year-end rather than the calendar year-end for common trust funds. This would allow for a more timely filing of trust tax returns since bank common trust funds require independent audits prior to preparing reports for the beneficiary.

We would appreciate a response indicating your position on this issue.

Very truly yours,

Debra J. Wheeler

Debra J. Wheeler
Tax Officer

DJW-CC.139

CHATTANOOGA, TENNESSEE 37401 TELEPHONE 615/757-3011

STATEMENT OF

AMERICAN SOCIETY OF COMPOSERS AUTHORS AND PUBLISHERS

On behalf of the American Society of Composers, Authors, and Publishers (ASCAP), I am pleased to have the opportunity to discuss the income tax problem that is a serious concern to our Society and its nearly 40,000 members.

BACKGROUND OF THE CAPITALIZATION ISSUE

Section 263A of the Internal Revenue Code, added by the Tax Reform Act of 1986, drastically altered the law regarding how creative professionals such as songwriters, authors and artists deduct their expenses. In essence, the law ended the practice of deducting all current professional expenses in the year that they are incurred. Instead, songwriters and other freelance artists were required to follow a complex accounting system called Uniform Capitalization. Under this new system, the songwriter apparently is required to estimate the income that each particular composition will earn and then deduct the related expenses as the income is earned.

Although there has been some disagreement among lawyers and tax accountants over the precise reach of this new law, it is quite clear that the IRS interpretation of it imposes immense new burdens upon songwriters and other creative professionals. Many songs and other creative works never earn royalties for the artist. Other works produce royalties that may last less than a year, but can extend for many years. It is highly impractical and burdensome to require artists to predict in advance the amount of income that each work will produce. Second, creative individuals would be required to make allocations among different properties for which there would be no reasonable basis. For instance, a typical composer writes many songs in one year, and often some of these songs are variations or revisions of earlier songs the composer wrote. The IRS has not given, and presumably will not give, practical guidance as to the version or versions to which the expenses would be allocated and the exact manner in which the expenses would be allocated.

THE TECHNICAL LANGUAGE NEEDED TO PROTECT COMPOSERS

ASCAP is especially grateful to those Congressmen and Senators who have perceived the threat posed by the new provision and have attempted to alleviate the problem. Last year, as a result of the efforts of Congressman Downey and Senators Moynihan and Bradley, the House of Representatives and the Senate Finance Committee adopted legislation that would have restored ordinary business deductions for some freelance artists. In accordance with the budget agreement reached last November between President Reagan and congressional leaders, however, these provisions were not adopted.

Upon close scrutiny and analysis of the particular language of these two provisions nearly enacted, however, we became concerned that they were inadequate. Each bill defined writer in part as the creator of "a musical or dance score." Although ambiguous, this language might be read to exclude lyricists and writers of popular songs, neither of whom it might be said create a "score" as that term is generally used in the music industry.

ASCAP has suggested that more precise language be used in order to protect these professionals from the provisions of Section 263A. We are most grateful that Congressman Downey recognized our concern about the technical problem with the previous language. Based on our recommendation, his most recent bill (H.R. 4473) defines writer in part as the creator of a "musical composition (including any accompanying words)." This language clearly exempted lyricists as well as composers of popular songs. Senator Domenici has also introduced a bill (S. 2351) exempting freelance artists from Section 263A. His bill, however, returns to the ambigious language nearly enacted last fall. We hope that the Senate Finance Committee will adopt the Senator's bill, but will utilize the more precise definition of "writer" from H.R. 4473.

THE IRS "SAFE HARBOR" IS INADEQUATE

I believe it is particularly important that this committee not be misled by the IRS regulations that recently proposed a "safe harbor" for creative professionals. Those composers who are subject to the Uniform Capitalization provisions believe that the IRS proposal is inadequate, inequitable, administratively burdensome, and a financial hardship. We do not believe that songwriters should wait three years before taking deductions routinely allowed for doctors, lawyers, accountants and other self-employed persons. All the while inflation will erode the value of the expenses that they finally receive years later.

The proposed IRS alternative, a three-year phased deduction of all artist's professional expenses, may increase rather than lessen the financial burden on many artists. The IRS alternative requires artists to apply the three-year method to expenses such as promotional and advertising expenses that are deductible in full in the year incurred under prior law and under Section 263A. In addition, the IRS alternative requires that the three-year method be applied even if the expenses relate to a work that was sold in the year created; these expenses also are deductible in full when incurred under prior and current law.

ASCAP firmly believes that the appropriate relief for its members must come from this committee and the Congress. The IRS regulations are administratively made and can be administratively modified to our detriment at any time.

CONCLUSION

We very much thank this committee for its consideration of the tax problem being faced by the economically vulnerable songwriting community. We respectfully request that the committee alleviate the financial burden that was imposed upon us by Section 263A by returning composers of music and other artistic creators to the legal situation that existed before the passage of the 1986 Tax Bill.

Statement Submitted
by the
Association of Oilwell Servicing Contractors
International Association of Drilling Contractors
International Association of Geophysical Contractors

This testimony is submitted jointly on behalf of the Association of Oilwell Servicing Contractors (AOSC), International Association of Drilling Contractors (IADC), and International Association of Geophysical Contractors (IAGC). As a group, these associations represent virtually the entire onshore U.S.-based oilfield service industries.

These industries have been greatly concerned about the changes in the collection of the diesel fuel excise tax wrought by the 1987 "continuing resolution" which rendered tax-exempt users of diesel fuel subject to that tax nevertheless, to be later applied to future taxes or recouped through a refund procedure. The associations are gratified that the House Ways and Means Committee chose to address this procedure, which has imposed very substantial administrative and financial burdens on our member constituent companies. However, the House bill, H.R. 4333, would provide that (quoting from the Ways and Means Committee description of the provision):

> "The ability to purchase diesel fuel direct from producers without payment of the Highway Trust Fund tax would be extended to other off-highway business users (e.g., farmers) who were permitted to make such purchases before April 1, 1988. Additionally, the definition of producer would be modified to include retail dealers that exclusively sell diesel fuel to waterway and marine users."

Thus, the IRS would retain the authority to define a "producer", which includes a "wholesale distributor", very narrowly, eliminating the many retail diesel jobbers which sell to oilwell-servicing, drilling and geophysical contractors.

The Internal Revenue Service (IRS) has long taken the view that a "wholesale distributor" of fuel is one who has a valid IRS-issued "certificate of registry". Typically, certificates of registry are given only to larger wholesalers of diesel fuel, and don't include the bulk of diesel fuel vendors who sell in the hinterlands of the nation, where in many circumstances there's one or only a very few vendors of diesel fuel, who perforce must sell to tax-exempt users and "on road" users, as well. The current House approach would essentially not rectify the problem for the greater number of contractors and farmers who've little or no choice in their selection of a diesel fuel vendor who most often wouldn't qualify for the IRS certificate of registry.

Therefore, AOSC, IADC and IAGC urge the Senate Finance Committee to modify the House approach to this problem by instructing the IRS--through statutory language--not to collect this tax from tax-exempt users of diesel fuel.

ATLANTIC
ENERGY

J. G. Salomone
Vice President and Treasurer

July 20, 1988

Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
U. S. Senate
S. D. - 205, Dirksen Senate Office Building
Washington, D. C.   20510

Re: S-2238, Technical Corrections Legislation

Dear Senator Bentsen:

Atlantic Energy, Inc. is an investor owned holding company whose primary business is the generation, transmission and distribution of electric energy to one-third of the State of New Jersey through its primary subsidiary, Atlantic City Electric Company. We value the opportunity to comment on certain provisions of the Technical Corrections Legislation (S-2238) now before the Senate Finance Committee, and ask to have our comments made a part of the formal testimony of the Committee's proceedings.

We understand that certain provisions of this proposed legislation if passed, would reduce the intercorporate dividends received deduction (DRD) to 50% by 1991. We are writing to express our continuing concern regarding the preservation of the DRD at its current level. In late 1987 we contacted key Congressional members to express our opposition to then proposed legislation which sought to reduce or eliminate the DRD. Our concerns regarding the currently proposed legislation remain unchanged and are twofold.

In the first case, multiple taxation will result. The intent of the DRD is to promote tax fairness and mitigate multiple taxation. Multiple taxation occurs when a corporation pays dividends which are not deductible to another non-affiliated corporation. The recipient corporation then pays a tax on the dividend income received, and when the recipient corporation pays this income without a deduction to its shareholders, those shareholders also pay a tax. The effect of further reducing the DRD is to further reduce the tax fairness that the DRD has provided over the years.

In the second case, the price of electricity will increase. Atlantic Electric is a capital intensive company and for years, has relied on senior equity securities, notably preferred stock, to provide an important source of moderately priced capital. Senior equity makes up approximately 10% of our capital structure, and our current financing plans project that 40% of our financing requirements will be raised through the sale of senior equity through 1992. Our ratepayers, the citizens of Southern New Jersey, have benefitted from our ability to raise moderately priced funds from the sale of these securities. But the enactment of the Tax Reform Act of 1986

Atlantic Energy, Inc.   1199 Black Horse Pike   Pleasantville, New Jersey 08232   609-645-4411

and the Omnibus Budget Reconciliation Act of 1987 which together reduced the DRD from 85% to 70%, along with the changes to the DRD proposed in S-2238, have had a disturbing effect on the price of these securities and the availability of capital, as investors seek higher returns to compensate for the loss of the DRD, or look to investments unencumbered by legislative uncertainty. Increases in the cost of these securities or a scarcity of investors result in a higher cost of capital for Atlantic Electric, a cost ultimately borne by our ratepayers.

Atlantic Electric serves over 400,000 customers in the southern one-third of New Jersey, an area with a population in excess of one million residents. Our continued vitality depends on an ample supply of electric power, and we are engaged in a major construction program to meet that need. Access to moderately priced capital is essential for us to successfully fulfill our public responsibility while at the same time keeping the rates charged to our customers at the lowest possible levels.

I appreciate the opportunity to express Atlantic Energy's views on this important matter and we urge the Committee to oppose the proposed DRD provision in the pending legislation. Should you or your staff require any additional information, I would be pleased to respond to your inquiry.

Sincerely,

cc: Senate Finance Committee Members
Mr. E. Mihalski
Ms. L. Wilcox
Committee on Finance
U. S. Senate
S. D. - 205 Dirksen Senate Office Building
Washington, D. C. 20510

City of Beaverton

July 20, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

-- Repealing Section 89;

-- Delaying Section 89's effective data to at least a year after Treasury issues final regulations;

-- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Steve Foster
Personnel Director

STATEMENT

of the

BLUE CROSS AND BLUE SHIELD ASSOCIATION

This statement is submitted by the Blue Cross and Blue Shield Association. The Association is the coordinating organization for the 77 Blue Cross and Blue Shield Plans throughout the United States. We cover approximately 68 million individuals under employer sponsored group health benefit plans.

We support the principle expressed in the Section 89 nondiscrimination rules that if highly compensated employees receive health benefits from their employers which are much more generous than the benefits available to nonhighly compensated employees, the excess portion of those benefits should not be tax-favored.

We are concerned, however, that the existing Section 89 provisions, which are due to go into effect for plan years beginning in 1989, will prove to be overly complicated and expensive to administer. From the perspective of health policy, the rules as presently structured may cause employers to reduce levels of coverage, in some cases even eliminate any contribution toward family coverage. Furthermore, we are concerned that employers may reduce the benefit options they might otherwise make available to their employees. The availability of choice among various benefit plans is important in meeting the needs of low income, single parents and two income families - needs often not adequately met by traditional plans. Multiple choice arrangements are also useful in containing health care costs.

These concerns motivated our early and active involvement in the Section 89 Coalition which has adopted as its goal the simplification of Section 89 and the provision of enough time between the publication of regulations and their effective date to permit employers to prepare adequately for the data gathering and testing of benefit plans as required by law.

The Association supports a one year delay in the effective date of the regulations. However, if for budgetary reasons a delay is infeasible, we urge you modify the rules to provide relief to employers and to mitigate the negative impact on multiple choice offerings.

S. 2238 and H.R. 4333, identical technical amendments bills introduced in March of this year, contain a number of changes in Section 89 that will make the nondiscrimination rules more manageable. One particularly important amendment would provide an interim method by which employers could value their health benefits for testing until the Treasury Department issues the valuation tables called for in the law.

SECTION 89 AMENDMENTS APPROVED BY WAYS AND MEANS COMMITTEE

In addition to the amendments included in H.R. 4333 and S. 2238, as introduced, the Committee on Ways and Means has approved a number of practical improvements that will facilitate the testing of employee health benefit plans for nondiscrimination. Everyone interested in Section 89 appreciates the effort and cooperation that the Committee and its staff, as well as the staff of the Joint Committee on Taxation, have displayed in arriving at the changes the Committee recently approved. Nevertheless, we would like to address several of the changes approved by the Ways and Means Committee and suggest slight modifications that would improve their simplifying effect.

One Day Testing

Under a major change approved by the Ways and Means Committee, employers would test plans based upon their status on one day each year rather than having to adjust for changes in employee eligibility and enrollment throughout the year. However, under this new testing procedure an employer would still have to take into account any changes in plan design or any change in benefits elected by a highly compensated person during the year. We believe that if the only elections a plan allows highly compensated employees to make during the year are those which reflect changes in family status, an employer should not have to adjust for those elections. This further modification in the provision approved by the Ways and Means will mean that if an employer makes all changes in plan design prior to the beginning of a plan year and highly compensated employees are allowed to make changes during the year only with respect to coverage of dependents, testing can be done entirely on the basis of a one-day "snapshot" - a major simplification achieved without in any way undermining the intent of the rules.

Employees Who Opt Out of Coverage

The Ways and Means Committee approved an amendment that would allow employers, under the 80% coverage test, to disregard employees or their family members who have opted out of coverage because they have core benefits under another employer's plan. Under existing law, this can only be done under the 75% benefits test. In a change applicable to both the 75% benefits test and the alternative 80% coverage test, the Committee amendment provides that nonhighly compensated employees and their families may not be disregarded if they opt out due to other health coverage unless the employer allows them, if the other coverage ceases, immediately to get back into the employer's plan on the same terms as if the employee were changing coverage during an open season.

The intent of this provision is to assure that these employees not be denied coverage. However, the language approved by the Committee would have the unintended effect of allowing employees to switch back and forth between two employer's benefit plans whenever it suits their needs. For example, an employee could opt out of an employers plan for a less generous plan from another employer, which is also less expensive for the employee, and then, having become seriously ill, to drop the other employers coverage and opt into the first employers plan in order to take advantage of its better benefits.

To prevent this type of adverse selection we urge that the language approved by Ways and Means be changed to provide that persons who wish to opt into an employers plan due to loss of coverage provided by another employer are to be treated under the same rules that the employer applies to any late entrant. If, under the employer's plan, late entrants are required to show evidence of insurability, then the same requirement also should apply to persons opting into the employers plan due to the loss of other coverage.

Sampling

Under another Ways and Means approved provision, employers would be allowed to perform the Section 89 tests using a statistically valid random sample of all employees, if performed by an independent third party, provided the statistical method and sample size produce a 99 percent level of confidence that the results will have a margin of error not greater than 2 percent.

While this sampling provision could greatly benefit large employers, we think the 99 percent tolerance allowed is so strict that, as a practical matter, sampling will seldom be a usable option. Modification of the provision to require a 90 to 95 percent level of confidence rather than 99 percent, would increase considerably the usefulness of the sampling option for employers without any real prejudice to the overall accuracy of nondiscriminating testing.

Aggregation of Comparable Plans for Testing

Generally, Section 89 provides that an employee's health benefit plan may be combined and tested as one plan if the employer-provided value of each plan is within 5% of those plans with which it is combined. The Ways and Means Committee approved an alternative to the 80% coverage test under which plans within 20% of each other in value rather than 5% may be combined and deemed to pass the nondiscrimination tests if the resulting one plan covers 90% of the employer's nonhighly compensated employees. We believe this more liberal 20% "comparability" rule is a real step in the right direction. Under the limited circumstances allowed by the 90% coverage requirement, some employers will be able to test as one plan multiple choice health benefit arrangements in which the range of values vary by as much as 20%. This is extremely important because (under the eventually-to-be-issued Treasury Department tables) some managed care benefit options, such as HMOs, may be valued for testing purposes as much as 20% higher than traditional plans, such as indemnity benefits, that actually have the same cost.

The personal value which employees place upon indemnity plans, and HMOs or other benefit alternatives, as opposed to their relative cost, depends heavily upon the self-perceived needs, lifestyle, family and financial circumstances of each employee. The attractiveness of multiple choice health benefit arrangements is due to employees being able to choose health benefits that best suit their needs while employers can introduce cost containment features along with those benefit choices. Thus, multiple choice arrangements increase employee satisfaction, while overall health benefit costs are better controlled. However, under Section 89, unless an employer can combine all of the health benefit options and test them as one plan, there is a possibility that one or more options or even the entire multiple choice arrangement might fail the nondiscrimination tests because too many highly compensated or too few nonhighly compensated employees are voluntarily enrolled in the most highly valued options. This possibility, plus the extra complexity of testing multiple plans under Section 89, as compared to testing a single plan, will deter employers from implementing multiple choice health benefit arrangements which would better serve both their own interests and those of their employees.

In order to facilitate the aggregation of plans in all testing situations - but particularly in multiple choice arrangements - we strongly recommend that for all of the nondiscrimination tests which currently allow comparable plans to be combined for testing, the allowable variation in employer-provided value among plans be raised from the existing 5% to 20% as the Ways and Means Committee has done in its new 90% alternative coverage test.

OTHER NEEDED CHANGES

Line of Business Testing

Current law allows employers to apply the nondiscrimination tests separately to separate lines of business or operating units. This ability to test separately is extremely important to many employers, not only because separate testing may allow some benefit plans to pass the tests, where they could not do so if combined with an employer's other plans, but also because many commonly owned lines of business and operating units do not have compatible employee benefit data systems. Testing by line of business will allow many employers to avoid the considerable expense of creating uniform data systems.

Because detailed requirements and regulations for line of business testing are unlikely to be ready sufficiently soon to enable employers to qualify their business units for separate testing when Section 89 goes into effect next year, it is extremely important that liberal transitional provisions be provided to facilitate the initial qualification of lines of business. The Section 89 Coalition has proposed a transitional rule for this purpose and we urge that it be adopted in order to prevent the Treasury Department becoming inundated with employer requests for line of business determinations in the early years of Section 89 testing.

Cafeteria Plans

The health and group term life insurance benefits offered under Section 125 cafeteria plans are also subject to nondiscrimination testing under Section 89. There are several questions concerning the interface between Sections 89 and 125 that need to be resolved in order for employers to understand how to go about testing their cafeteria plan benefits under Section 89. Those questions are highlighted in Attachment I appended to this statement.

Safe Harbors and Further Simplification

We support the adoption of safe harbors which will allow qualifying employers plans to be deemed to pass Section 89 based upon their design and rules for participation without the need for employers to gather data on individual employees and actually perform the Section 89 tests.

The Section 89 Coalition has proposed two such safe harbors which would greatly facilitate testing in multiple choice situations that meet the criteria set forth in them. Those safe harbors are described in the Coalition's statement submitted for the record of this hearing and we commend them to your attention.

In addition, the Blue Cross and Blue Shield Association would like to offer for the committee's consideration an optional set of two tests that employers could use in place of the existing 90%/50% eligibility test and the 75% benefits test. This optional set of tests is described in Attachment II. We believe it would yield results comparable to the existing tests while relieving some employers of the need to account for which individual nonhighly compensated employees are enrolled in each plan. Importantly, it would also provide a simplified procedure for the calculation of the taxable income attributable to highly compensated employees where benefit plans fail the optional tests. These optional tests would be particularly useful for companies with more than one benefit plan and 500 or fewer employees. Most small employers can ill afford the expense of retaining benefit consultants to assist them in coping with the complexities of Section 89.

In conclusion, we wish again to state our support for the principles which led to enactment of Section 89 and to reiterate our support for delay of the effective date for one year. If this is not feasible, we urge the Committee on Finance to make additional changes, as outlined in this statement, to minimize both its negative impact on the offering of multiple choice health benefits and the effort and expense employers will have to undergo in order to show that their benefit plans do not unduly favor highly compensated employees.

BP America Inc.
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216-586-4141

BP AMERICA

July 22, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205 Dirksen Senate Office Building
Washington, D.C. 20510

Senate Finance Committee
Washington, D.C.

Dear Committee Members:

We at BP America are concerned about the forthcoming implementation and ongoing administrative requirements to comply with compliance in Section 89 of the Tax Reform Act of 1986. We appreciate the changes to Section 89 included in the Ways and Means technical corrections bill, but feel strongly that further simplification is needed in order for employers to reasonably comply.

As the Section is currently written, we believe it to be virtually impossible for most large employers to gather the data necessary for testing and be prepared to comply effective January 1, 1989. Very rough estimates put our potential costs as high as $1-2 million in programming, systems and personnel costs in the first year to gear up for Section 89 testing. The administrative costs of running the tests will likely be very nearly as high in succeeding years as well. These costs to us will result in a correspondingly large reduction in our federal taxes. It is our belief at this stage that reductions in taxes due to these increased costs for most large companies will more than offset any tax penalties which might result from non-compliance.

In preparing for 1989 compliance, employers are forced at this time to make many individual interpretations of the law due to the lack of regulatory guidance. Valuing of plans, handling of former employees, lines of business, and many other issues are unclear and subject to interpretation. Depending upon eventual regulations, some choices made by employers now could result in backtracking, retesting and significant additional costs for changes in computer programming, etc., when the regulations become available.

Further, many areas of the law which have been clarified present such difficulties in administration, that reactions contrary to the intent of the legislation may result. For example, under the current definition of a "plan" in Section 89, our organization has several hundred separate "plans" for valuing and testing. In light of these exceedingly complex requirements, there is no doubt that many employers will seek to simplify their testing burden by eliminating various plan options, or even plans themselves. Unfortunately, employees will have their options and flexibility in choosing benefit packages reduced as a result.

Of particular concern to many large enterprises will be the possible competitive restrictions imposed by line of business rules for benefits testing. The present law governing determination of a "line of business" for purposes of Section 89 is vague and difficult to interpret and apply.

A major difficulty is the practical separateness of lines of business within a vertically integrated enterprise. Although a manufacturer may sever a resource, process the resource to a basic raw material, fabricate the raw material into a part, component or marketable commodity, distribute the part or commodity, and market the product at retail, these operations may function economically and practically as separate lines of business. Requiring a vertically integrated operation to provide similar benefits to all operations could seriously jeopardize the competitive viability of some. This is a particular concern where non-integrated competitors operate at various segments of the chain.

Further, allocation of central administrative groups to various lines of business becomes a huge administrative task for large employers. As these groups provide unique services to the benefit of many different lines of business, they are in their own right operating as a line of business and are virtually impossible to "allocate."

In conclusion, we recognize and appreciate the goal of non-discrimination in provision of welfare benefits. We believe, however, that many aspects of the current law in Section 89 may have a detrimental effect on benefits provided due to complex and costly administrative requirements. The goal of non-discrimination can and should be reached through a simplified, workable process. To summarize, we suggest:

- o Reduction of data gathering requirements by requiring once-a-year, point-in-time testing only.
- o Delay of the effective date, and/or a phased-in implementation allowing at least six months after issuance of regulations for employers to prepare for testing.
- o Safe harbors allowing plans to pass without the need for testing if they meet certain requirements in employee cost and plan design.
- o Flexibility in line of business designations to allow competitive viability for vertically integrated organizations, and central administrative groups to be considered a separate entity.

Thank you for your time, and we appreciate your efforts to create an effective and reasonable law for employees and employers.

Very truly yours,

Paul S. McAuliffe
Director, Benefits, EEO & Labor

PSM:SLC:mlh-24

STATE OF CALIFORNIA
GEORGE DEUKMEJIAN, *Governor*

DEPARTMENT OF PERSONNEL ADMINISTRATION
OFFICE OF THE DIRECTOR
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July 28, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

As Director of the State of California's Department of Personnel Administration, I am responsible for overseeing the application of Section 89 of the Internal Revenue Code to our State's employee benefit plans. With 150,000 employees and literally dozens of plans, the discrimination tests contained in this section will require an extensive and highly complicated testing process for plans which, on their face, obviously do not contain the types of abuses that Section 89 is intended to address.

Section 89, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination, particularly for employers such as the State, which provide virtually identical benefit choices from the top to the bottom of their work forces?

While there is a slightly easier "alternate coverage test", because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization - as they may be required under State and Federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated" but who are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards - you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives, including ones that would allow uniformly structured plans, such as the State's, to pass on the basis of their obviously non-discriminatory provisions.

Your consideration of our imput is appreciated.

Sincerely,

James D. Mosman
Director

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July 24, 1988

BY HAND

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
205 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: S.1350/H.R. 2636, The Technical Corrections Act of 1987

Dear Senator Bentsen:

We are writing on behalf of the Cafritz Foundation, Washington, D.C. to request that the Committee on Finance approve a technical correction to Section 4943 of the Internal Revenue Code of 1986, as amended, granting an across the board five year deferral of the date requiring foundations holding 95% of the stock of an operating business as of 1969 to reduce their ownership of such businesses to 50% or less by May 26, 1989.

The Cafritz Foundation is the largest private foundation serving the Washington metropolitan area. It has made grants in excess of $54 million since 1970. All grant requests are reviewed and approved by a panel of 12 distinguished citizens including Daniel Boorstin, the former Librarian of Congress, S. Dillon Ripley, the former Secretary of the Smithsonian Institution, J. Carter Brown, the Director of the National Gallery and others.

Excess Business Holdings Under the Tax Reform Act of 1969. In 1969 the Congress took action to restrict private foundations from owning operating businesses. There was concern that businesses owned by foundations had an unfair competitive advantage, deferred charitable benefits by reinvesting earnings in their operating businesses and were subject to pressures requiring them to focus more on commercial enterprises than on charitable purposes. Section 4943 was added to the Internal Revenue Code to prohibit "excess" business holdings. A special rule applies to certain holdings acquired prior to 1969.

Private foundations owning more than 95% of the stock of an operating business as of 1969 are required to reduce their ownership to 50% or less in 1989. They are further required to reduce such holdings to 35% or less by the year 2004.

Cafritz Foundation Holdings. The Cafritz Foundation received various commercial and residential real estate properties and several business holdings upon the death of Morris Cafritz in 1964. A construction company, a hotel and an insurance company have been fully divested. The foundation's sole remaining business holding is a small real estate management company, the Cafritz Co., which principally manages the real properties that constitute the bulk of the Foundation's investment assets. Cafritz Co. had net income last year of less than $175,000 and represents less than 2% of the Foundation's assets.

Need for 5 Year Deferral of Divestiture Date. The Foundation urges a 5 year extension for these reasons:

1. One third of Cafritz Co. is owned by a trust for the benefit of Mr. Cafritz's widow who is advanced in age. The holdings of that trust must be aggregated with the Foundation's holdings. If the Foundation is required to reduce its holdings before the trust terminates, the Foundation can retain only a 16 2/3% interest rather than the 50% interest permitted under the Code. Moreover, the Foundation will later have to dispose of all but an additional 3 1/3% of the Cafritz Co. stock it receives from the trust. (See explanation below).

2. Such massive divestiture will have a far greater disruptive effect than Congress intended. The Foundation will be denied a sufficient ownership interest in Cafritz Co. to assure continuity of the present high level of management services needed for the aging buildings owned by the Foundation. Moreover, a number of older devoted employees are likely to lose jobs that they will not be able to replace.

3. A brief postponement of the divestiture date will not affect revenue or make possible any of the abuses at which the law is aimed. Cafritz Co. represents less than 2% of the Foundation's assets. All of the company's income is subject to full taxation and all of its after tax income has been and will continue to be dividended to the Foundation and trust.

Cafritz Foundation and Current Law. Section 4943 of the Internal Revenue Code of 1986, as amended, (the "Code") imposes penalty taxes on the "excess business holdings" of private foundations. Excess business holdings include stock held by a private foundation where the foundation and "disqualified persons" together hold more than 20% of the voting stock of the issuing corporation. Generally, substantial contributors, foundation managers, their families, entities they control, and other similarly related parties are all disqualified persons.

As a general rule a private foundation that acquires a stock interest which constitutes excess business holdings by gift of bequest is allowed five years to divest itself of such excess holdings before any tax is imposed. Section 4943(c)(4) and (5), however, provide special rules for excess business holdings acquired before May 26, 1969. For example, if a private foundation receives an interest constituting excess business holdings under a pre-1969 bequest, and the private foundation and all disqualified persons together hold more than 95% of the voting stock or equity of the enterprise, the excess business holdings are required to be disposed of by 1989.

In the case of the Cafritz Foundation, because a trust created for the benefit of Mrs. Cafritz holds 1/3 of the stock of the Cafritz Co. and the trust is deemed to be a "disqualified person" for purposes of the divestiture rule, in determining the permitted holdings of the Cafritz Co. by the Foundation, that 1/3 interest is aggregated with the 2/3 interest held by the foundation. Accordingly, if Cafritz foundation is to comply with the divestiture rule, it must divest itself of 50% of the stock of the Cafritz Co. The Foundation only controls 66 2/3% of the stock of the Cafritz Co. After the mandated sale the foundation would be left with only 16 2/3% of the stock of the Cafritz Co. Subsequently, when the Foundation receives the 1/3 interest now held by the trust, it will be required to dispose of any stock interest in excess of 20% of the Cafritz Co. because the stock transferred by the trust is treated as stock acquired after 1969. The Foundation is thus subject to the general provisions of Section 4943 rather than the transition rule permitting a foundation to retain up to 50% of its excess business holdings through 2004.

Consequently, we hope the Committee on Finance will act to grant an additional 5 year period for all private foundations affected so their ownership arrangements can be altered and those foundations in the process of selling their excess business holdings can have this brief additional period to continue negotiating the most favorable terms possible for the benefit of the charities they support.

Thank you for your consideration.

Sincerely yours,

William Morris

Cavenham

July 18, 1988

Ms. Laura Wilcox, Finance Administrator
U.S. Senate Committee on Finance
SD-205, Dirkens Senate Office Building
Washington, D.C. 20510

Subject: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

The Tax Reform Act (TRA) of 1986 has expanded the employer recordkeeping responsibility greatly with Section 89 of the Internal Revenue Code (IRC). As an employer, we already have unreasonable data collection and analysis requirements, and Section 89 only heightens this responsibility.

Although the idea of nondiscrimination in benefits is a laudable concept, the impact of the rules are overwhelming. It is really not necessary to use such a complicated and detailed method to prove nondiscrimination with employee benefits. Congress should reconsider this legislation before it is effective.

The benefits professionals such as me suggest that you consider the following alternatives:

- Repeal Section 89;
- Delay Section 89's effective date at least a year after the Treasury Department has issued final regulations;
- Simplify the rules significantly; and
- Develop safe harbor alternates.

Your consideration is appreciated.

Sincerely,

David J Brown

David L. Brown, Manager
Corporate Compensation & Benefits

DLB/cm

Cavenham Forest Industries Inc.
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Mailing Address P.O. Box 3396, Terminal Annex Los Angeles, California 90051

CERGRO

CERTIFIED GROCERS OF CALIFORNIA, LTD.

July 18, 1988

Laura Wilcox
Hearing Administrator
U.S. SENATE COMMITTEE ON FINANCE
SD-205, Dirksen, Senate Office Bldg.
Washington, DC 20510

Dear Ms. Wilcox:

BELOW ARE CERTIFIED GROCERS COMMENTS. THEY ARE TO BE MADE A PART OF THE RECORD OF THE SENATE FINANCE COMMITTEE HEARING ON TECHNICAL CORRECTIONS HELD ON JULY 13, 1988.

Certified Grocers is a retailer-owned wholesaler. We have 2,500 employees who are covered by a variety of benefit plans. We support 3,000 independent retailers with products and services. We often speak for them, as is the case here, in matters of government regulation and legislation.

Certified Grocers recognizes and supports the goal of non-discrimination. Certified Grocers also recognizes and supports the goal of simplicity in benefit plan design, administration and testing. These two goals need not be in conflict. However, I am concerned that unless some changes are made in Section 89, the goals will be in conflict.

Proposed regulations will cost Certified Grocers a significant amount to gather data and run the necessary tests for our 20 plans. Unless there is an extension of the effective date of whatever regulations are finally approved we will not be able to modify our computer systems in time and must utilize clerical methods to gather the data. The 3,000 independent retailers we serve will have similar problems.

Certified Grocers urges the Senate Committee on Finance to:

1. Be sure the cost of the tests do not exceed the benefits.

2. Simplify the regulations.

3. Extend the effective date.

Sincerely,

CERTIFIED GROCERS OF CALIFORNIA, LTD.

Donald W. Dill
Sr. Vice President, Administration

DWD:ak

STATEMENT OF THE CONFEDERATED TRIBES OF THE WARM SPRINGS RESERVATION OF OREGON BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE CONCERNING HR 2792

Washington, D.C.

July 12, 1988

The Confederated Tribes of the Warm Springs Reservation of Oregon submit this statement as supplemental testimony concerning HR 2792.

The Warm Springs tribe wholeheartedly supports the purpose of HR 2792, which is to clarify the immunity from federal taxation of treaty-reserved Indian fishing rights. However, we strongly urge that Section 1(c)(3) of HR 2792 be modified or eliminated. This subsection contains objectionable language which could be read as a Congressional abrogation of treaty rights.

The Warm Springs tribe is a confederacy of Columbia River Indian people whose forefathers negotiated and expressly reserved in an 1855 treaty with the United States the right to fish at all usual and accustomed places, as they had done for countless generations. The traditions practiced by our ancestors, and reserved in the treaty, are today still the heart of our Indian way of life. Indeed, the treaty-protected fishing right, and other treaty rights, form the foundation of the Warm Springs tribal culture and religion.

The reserved fishing right was an especially important part of the negotiations leading to the Warm Springs treaty. In this treaty, our forefathers agreed to move to a reservation many miles from their traditional homes along the Columbia River and its tributaries. Our principal fisheries were on the Columbia and the lower reaches of its tributaries. In order to maintain our tribal way of life on a reservation far from the river, it was essential for us to leave the reservation to fish at our traditional places. The record of the treaty negotiations shows that our people would never have signed the treaty without the provisions reserving off-reservation fishing and other traditional food-gathering rights. Accordingly, these rights were specifically reserved in our 1855 treaty and have been exercised and enjoyed by virtually every member of our tribe for the 132 years since the treaty was signed.

It has always been our belief that the rights reserved in our 1855 treaty were absolute rights which could not be infringed upon or diminished by the states or the federal government. We have always viewed our 1855 treaty as securing forever our unencumbered right to fish at our usual and accustomed places off reservation, in the same way that our forefathers fished at treaty time in 1855 and before.

HR 2792 represents a declaration by Congress that the treaty-reserved fishing rights of Warm Springs and other Indian tribes should not be diminished by subjecting the exercise of that right to taxation by the Internal Revenue Service. For that reason, the Warm Springs tribe strongly urges passage of this legislation. At the same time, however, the tribe strongly objects to Section 1(c)(3) of the bill, which would have the effect of abrogating our 1855 treaty to the extent that it provides a basis for immunity from federal taxation. We are unalterably opposed to any modification, alteration, or abrogation of our 1855 treaty rights, even if such a provision is contained in legislation which we otherwise support.

Section 1(c)(3) is not only objectionable, it is unnecessary. Because HR 2792 has the effect of immunizing treaty-fishing income from taxation under the Internal Revenue Code, there is no reason for the legislation to state that Indian treaties "shall not be construed to provide an exemption from any tax imposed by this title." Accordingly, we urge the Subcommittee members to delete or modify the treaty abrogation language contained in Section 1(c)(3) before enacting HR 2792.

Thank you very much.

Zane Jackson, Chairman
Warm Springs Tribal Council

CIBA-GEIGY

CIBA-GEIGY Corporation
Ardsley, New York 10502-2699
Telephone 914 478 3131

July 18, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

I understand that the Senate Finance Committee was scheduled to hold a hearing on July 13, concerning technical corrections legislation (S.2238), including possible revisions to Section 89. While I realize that this letter will not reach you until after these hearings are held, I would like to express the opinion of CIBA-GEIGY Corporation on the effect of Section 89 and request that the letter be included in the hearing record.

CIBA-GEIGY is in complete agreement with the policy goal of Section 89. We support non-discrimination and strive to design our health and welfare benefits in a non-discriminatory manner.

Our difficulty with Section 89 arises from its administrative complexity and the enormous cost and utilization of the resources of my staff to gather data, design and implement the systems to run the tests, and then to monitor the welfare plans on an on-going basis.

In 1986, CIBA-GEIGY implemented a flexible benefits program. The company offers three medical plans to employees, two dental plans and, in addition, 79 HMOs are offered to our employees throughout the country. Each of these plans offer single, dual and family coverage.

The cost of each of these plans varies and CIBA-GEIGY makes an equivalent contribution to each. Thus, our employees may pay a premium for coverage, receive no cost coverage or receive a spending account contribution based upon their election and the cost of the plan they elect. Employees tend to sort themselves out in the way they feel best meets their personal needs.

Under Section 89, there are 84 plans under our Flexplan program, each with three options, or a total of 252 plans for testing. This number does not include our union or control group plans, or our life insurance plans. It seems unreasonable that 252 plans must be tested for a population of 10,000 employees.

Our employees are entitled to make their own elections and to change their election effective each January. The enrollment for the year 1989 is conducted in October 1988. Since we have no way of knowing which of the plans might be considered discriminatory because its "value" is considered greater than the "value" of another plan, we cannot alert employees to the fact that their elections may result in imputed income to them.

If CIBA-GEIGY were to return to a single medical plan and offer the minimum number of HMOs to maintain compliance with the HMO act, the company's ability to comply with Section 89 as it now stands would be much less costly and much simpler to achieve. Such a decision, however, would be very detrimental to our employers. Unfortunately, this is a decision that many employers will be forced to make.

CIBA-GEIGY is a member of the Washington Business Group on Health and the Erisa Industry Committee and supports the Section 89 changes proposed by the ERIC, APPWP and WBGH Simplification Working Group. We urge you to support our request for the implementation of simplifying changes to Section 89, regulatory guidance, and the lead time to implement the final provisions of Section 89.

Thank you very much for your willingness to hear our position.

Yours truly,

Michael J. Whelan
Director
Corporate Employee Benefits

MJW/rm

cc: C. Amkraut, WBGH
file: dh4-14

Statement Submitted
By A
Coalition of Maritime Companies
And Associations

This statement is submitted by a coalition of maritime companies and associations, a coalition encompassing the preponderance of the U.S.-flag merchant marine and drilling rig owners and related service industries. These companies and associations are:

American Commercial Barge Line Company (ACBL)
American Institute of Merchant Shipping (AIMS)
American Waterways Operators (AWO)
Crowley Maritime Corporation
Central Gulf Lines
International Association of Drilling Contractors (IADC)
Lake Carriers Association
Matson Navigation Company, Inc.
National Ocean Industries Association (NOIA)
Sea-Land Corporation
Totem Ocean Trailer Express (TOTE)
Transportation Institute (TI)
United Shipowners of America (USA)

Our coalition urges the Senate Finance Committee to incorporate in the Technical Corrections Act of 1988 a change to permit meals provided to crews on commercial vessels and to personnel on drilling rigs and platforms offshore and in the State of Alaska to be fully deductible.

A representative of the coalition, Jack M. Park, testified before the Senate Finance Subcommittee on Taxation and Debt Management on July 22, 1987 and a written statement was submitted in support of such a provision.

The justification for a correction to the Tax Reform Act of 1986 which would restore 100% deductibility for meals provided to employees on commercial vessels and on drilling rigs offshore and in Alaska is summarized as follows:

- It is a legal requirement to provide meals to merchant seamen.
- As a practical necessity meals must be provided by employers to crews on vessels and to personnel on drilling rigs.
- Meals provided to vessel crews and drilling rig personnel are as essential to doing business as other fully deductible costs.
- 80% deductibility is directly contrary to the purposes of various statutes making it a national policy to enhance the strength and competitiveness of our merchant marine.
- Revenue to the Treasury from the 80% rule would be de minimis.

A more detailed justification is included in our statement of July 22, 1987.

The House Ways and Means Committee adopted such a provision in H.R. 4333. It is described in the Committee Print Summary (WMCP 100-37) of July 15, 1988 (page 11) as follows:

> 4. Full Deductibility of Business Meals Provided to Employees on Certain Vessels and Oil Rigs
>
> The Committee agreed that the 20-percent reduction rule normally applicable to business meals would not apply to an otherwise allowable deduction for expenses of food or beverages that are provided on an oil or gas platform or drilling rig if such platform or rig is located either offshore or in Alaska. The provision would apply for taxable years beginning after December 31, 1987.
>
> The Committee further agreed that the 20-percent reduction rule would not apply to expenses of food or beverages which are required by Federal law to be provided to crew members of a seagoing commercial vessel (including vessels operating on the inland waterways, but not applying to luxury water transportation). The provision would be effective for taxable years beginning after December 31, 1988.

The Ways and Means Committee, in the provision restoring full deductibility as we have urged, has added certain qualifications to the language we proposed. The restoration would apply to food or beverages required by Federal law to be provided to crew members of a seagoing commercial vessel (including vessels operating on the inland waterways but not applying to luxury water transportation). The underlining identifies the qualifications.

The provision would be effective for taxable years beginning after December 31, 1987 in the case of drilling rigs; for taxable years beginning after December 31, 1988 in the case of commercial vessels.

We sincerely appreciate the action of the members and of the staff of the Ways and Means Committee in adopting this provision and interpret the summary as essentially reflecting our views. The qualifiers, "required by Federal law" and "seagoing", however, may pose some problems as they may be interpreted by the Internal Revenue Service. We suggest that any ambiguity which they create be eliminated either in the text of the provision or by report language. (The statutory language yet to be published may resolve ambiguities, but at this point in time we have only the summary to which to refer.)

The inclusion of both seagoing vessels and inland waterway vessels is very important and equitable and should be retained. The phrasing "...seagoing commercial vessel (including vessels operating on the inland waterways)...," however, is a contradiction which can be avoided by deleting the word "seagoing." Deletion of the word "seagoing" eliminates a definition problem (What is a seagoing vessel?), and does not appear to expand the universe of vessels beyond what is intended by the summary statement. We also urge that the words "Great Lakes and" be inserted before the words "inland waterways."

The phrase "...required by Federal law..." is consistent with our argument that full deductibility should be allowed for vessel crews' meals because employers are required to provide the meals. In our July 22, 1987 statement we described the pertinent laws. In the foreign and intercoastal trades meals are precisely described by statute, including, for example, the minimum mumber of calories. 46 U.S.C. §10303. While these particular statutorily prescribed meals are not required to be provided in the coastwise trades, other statutes do require the master of any vessel documented under the laws of the United States to provide "adequate and suitable" food and water on the vessel. 46 U.S.C. §10901 et seq. The statute sets forth specific civil penalties for failure to do so. 46 U.S.C. §10902. It is a criminal offense to withhold suitable food and nourishment from seamen on any type of voyage. 18 U.S.C. §2191. In order to insure that the Internal Revenue Service understands the underlying bases for the words "required by Federal law" it is suggested that these laws be referred to in the Committee report.

We take no exception to the qualifier, "...but not applying to luxury water transportation."

We view differing effective dates for oil rigs and commercial vessels as inequitable and urge that the provision be effective in both cases for taxable years beginning after December 31, 1987.

We urge the committee to adopt the provision on deductibility of crews meals as proposed by the House Ways and Means Committee, modified as discussed above.

We thank the committee for this opportunity to express our views and would be pleased to respond to any questions or requests for additional information which the committee members or staff may have. The person to contact is Jack M. Park, Vice President, Governmental Relations, Crowley Maritime Corporation, 1500 K Street, N.W., Suite 425, Washington, D.C. 20005; telephone (202) 737-4728.

STATEMENT OF C. WILLIAM FISCHER
VICE PRESIDENT FOR BUDGET AND FINANCE
UNIVERSITY OF COLORADO

Submitted for Record at Hearing on
Tax Technical Corrections
Conducted by
The Senate Finance Committee
July 13, 1988

My name is C. William Fischer, and I am Vice President for Budget and Finance at the University of Colorado. I want to thank the Committee for holding a hearing on tax technical corrections that have been considered by the House Ways & Means Committee but that have not yet been considered by the Senate Finance Committee. I am especially thankful for the opportunity to testify on recent developments that could undermine the final implementation of a tax-exempt bond financed self-insurance plan that the University of Colorado has been working on for nearly a year. On behalf of the University and other similarly situated state and local government entities, I respectfully request that the Committee adopt report language confirming the availability of tax-exempt bond financing of self-insurance plans for state and local government entities.

Before I address the specific problems created for tax-exempt bond financed self-insurance plans by S. 2238 and its companion version under consideration in the House of Representatives, (H.R. 4333), let me digress to provide the Committee with background information on how those plans work, and on the University of Colorado.

The University of Colorado was founded in 1876 with a campus in Boulder, Colorado. Growth of the university over the years has been phenomenal. Today, the university employs about 17,000 people, serving over 40,000 students on 4 campuses in Boulder, Denver and Colorado Springs. Our total budget exceeds $650 million. The size of the University's operations and the public education, research, and health care services it provides result in it having large liability insurance needs.

As a result of the insurance liability crisis, however, the University of Colorado and many state and local government entities are increasingly unable to purchase insurance coverage at reasonable prices, if at all. An attractive alternative to purchasing insurance has been tax-exempt bond financed self-insurance plans. These plans provide insurance for traditional governmental purposes at substantial savings over the premium payments for insurance purchased from insurance companies, assuming such coverage can even be obtained.

Tax-exempt bond financed self-insurance plans implemented by state and local governments operate in the following way. Working with insurance consultants, actuaries and other professionals knowledgeable in insurance matters, the governmental unit projects its anticipated claims and losses over a period of years. The projections are made using well-established actuarial methods for projecting such matters. Having thus determined its reasonably anticipated claims and losses, the governmental unit issues tax-exempt obligations in an amount such that, during each year covered by the self-insurance program, the proceeds of the obligations will be available to pay such claims and losses as they arise. For example, if the actuarial projections indicate that the governmental unit will experience claims and losses in the amount of $50,000 each year for five years, tax-exempt obligations would be issued in the approximate amount of $250,000 (adjusted for inflation during the period in question and the costs incurred in issuing the obligations). The proceeds of the obligations are then invested in U.S. Treasury obligations and other highly-rated investments which will mature at such times as will produce the amounts needed to pay the claims and losses that arise each year. If, in a particular year, the claims and losses exceed those projected, the investments are liquidated prior to their maturity to the extent necessary to produce the cash needed to pay such claims and losses. If the claims and losses are less than projected, unexpended proceeds continue to be invested and held to pay the claims and losses that will arise in the future. In the ordinary course, actual claims and losses will not be level from year to year but will vary based on the circumstances that constantly change.

It should be noted that, because the proceeds of the tax-exempt obligations will not be substantially expended within the three year temporary period allowed under existing Treasury Department regulations, the obligations can only be tax-exempt if the proceeds thereof are invested at a yield which does not exceed the yield on the tax-exempt obligations. Thus, there is no opportunity for the governmental unit to earn arbitrage profits. As a practical matter, the proceeds will generally be invested at a yield which is substantially less than the yield on the tax-exempt obligations, resulting in "negative" arbitrage--that is, the cost of paying debt service on the tax-exempt obligations will be greater than the investment earnings derived from the investment of unexpended proceeds. However, the purpose of a bona-fide self-insurance program is not to earn arbitrage on tax-exempt bond proceeds (which is prohibited under existing law in any event), but to provide an assured source of funds, or insurance reserve, for the payment of claims and losses that arise during the period covered by the program.

Implementation of tax-exempt bond financed self-insurance plans has allowed the University of Colorado to avoid massive increases in insurance liability costs. As a result of these savings, the University has not been forced to pass through to the public increased insurance liability costs in the form of increased taxes, increased tuition fees, or increased insurance costs for the University's employees. Beginning in 1984, the University began to experience unacceptable liability insurance premium increases. In that year, for example, the University, with state government approval, implemented a tax-exempt bond financed self-insurance plan for workers compensation claims which cost approximately $1.3 million. The annual premium quoted the University for similar coverage was approximately $3.2 million. In 1985 the quoted insurance premium for primary medical malpractice insurance was scheduled to rise nearly three-fold, from $680,000 to $1.8 million. As a result of implementing a tax-exempt bond financed self-insurance plan, the University was able to actually reduce its primary medical malpractice rate to an estimated $600,000. Again last year, when faced with an unacceptable increase in its auto and general liability insurance premium, the University implemented a tax-exempt bond financed self-insurance plan that is projected to result in annual savings of approximately $100,000. In short, savings in insurance payments for workers compensation, medical malpractice, and auto and general liability insurance have totaled over $9 million during the past 4 years compared with rates quoted by private insurance companies.

The University of Colorado is not the sole beneficiary of savings provided by tax-exempt bond financed self-insurance plans. Other examples of state and local governments about to implement self-insurance plans that I am aware of include Adams County, Colorado; the City of Dallas, Texas; a school district in Cheyenne, Wyoming; and the Contra Costa County, California.

The issuance of tax-exempt bonds to finance self insurance plans is currently allowed under the Internal Revenue Service code, as modified by the Tax Reform Act of 1986. The tax-exemption is allowed because the bonds finance public, government purposes. The Reform Act continued tax-exempt bond financing for governmental purposes and, in reliance upon the ability to issue tax exempt bonds to finance self-insurance plans, several state and local governments are in the final stages of implementing such plans.

The Reform Act also continued and expanded general restrictions on the ability to invest bond proceeds at yields materially higher than the yield of the issue. Nonetheless, despite the restrictions on arbitrage transactions enacted as part of the Reform Act, certain arbitrage transactions have occurred, most notably the so-called "Deerfield" and "escrow" transactions. To address these abuses, language was included in S. 2238 and H.R. 4333 (Section 113(a)(43) of the bills) intended to prevent abuses under Section 148 of the Code through so-called Deerfield transactions by further defining "investment property" under Subsection (b) of section 148 of the 1986 Code to include tax-exempt private activity bonds subject to the federal individual alternative minimum tax.

In addition, the bills contain language (Section 113(a)(34)) giving the Treasury Department broad regulatory authority to limit arbitrage-motivated transactions. That regulatory authority is intended to permit the Treasury Department to eliminate any devices designed to promote issuance of bonds either partially or wholly as investment conduits in violation of the provisions adopted by Congress to control such activities and to limit the issuance of tax-exempt bonds to amounts actually required to fund the activities for which their use specifically has been approved by Congress. Further, that regulatory authority is intended to permit Treasury to adopt rules (including allocation, accounting, and replacement rules) necessary or appropriate to accomplish the purpose of the arbitrage restrictions, which is to eliminate significant arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer. Such a broad authority is a necessary response to the narrow interpretation of the Treasury Department's regulatory authority in a recent federal court decision, City of Tucson v. Commissioner, 820 F2d 1283 (DC Cir 1987).

Although the University of Colorado supports the broad grant of regulatory authority, it fears that such authority might be used inadvertently to prevent legitimate transactions--such as tax-exempt bond financed self-insurance plans--which are not motivated by the desire to earn arbitrage on tax-exempt bond proceeds. These fears were highlighted as a result of a recent meeting involving Treasury Department officials. Those officials indicated that the Department intends to promulgate additional rules preventing arbitrage-motivated transactions. Specifically, under the rules suggested, an entity issuing tax-exempt bonds would be required to spend 85 percent of the bond proceeds within three years. Although the University of Colorado supports efforts to prevent arbitrage motivated transactions on tax exempt bond proceeds, the unintended effect of such rules could be to prohibit the issuance of tax-exempt bonds to finance self-insurance plans. As explained above, these plans, by their nature, require lengthy delays between the dates upon which bonds are issued and bond proceeds are spent.

In short, the University of Colorado is concerned that the financing of self-insurance plans with tax-exempt bonds might be prohibited by the unintended effect of Treasury Department rules promulgated under Section 113(a)(34) of S. 2238 and H.R. 4333 for the purpose of deterring arbitrage-motivated transactions. Even uncertainties created by the possibility of such rules being promulgated will have a chilling effect on the self-insurance plans about to be implemented. If the uncertainty surrounding the broad grant of regulatory authority to the Treasury Department is not cleared up by Congress, self-insurance deals which state and local government entities have worked long and hard on--and which provide substantial insurance cost savings to their constituents-could be killed.

To prevent this unfortunate and unintended affect on self-insurance plans, I respectfully request that the committee include language in the report accompanying S. 2238 confirming that the availability of tax-exempt bond financing for self-insurance plans should continue unimpaired. Specifically, the language should state that it is not the Committee's intention that the Treasury Department penalize tax-exempt bond financed self-insurance plans for state and local governments where, based on actuarily-determined insurance needs, the proceeds of the bonds may not be expended during the first several years following the issuance of bonds. So long as the unexpended tax-exempt bond proceeds are invested at a yield which is not materially higher than the yield on the bonds, the availability of tax-exempt bond financing for such plans should continue unimpaired. Suggested report language is attached to my testimony. It would not result in any revenue loss because it does not involve a change in existing law.

Again, I thank the Committee for holding hearings on the tax technical corrections. Please feel free to contact me if you have questions about my testimony or if I can be of further assistance.

JCR:shw/jmc
895

Confederated Tribes and Bands
of the Yakima Indian Nation

Established by the
Treaty of June 9, 1855

July 22, 1988

Honorable Max Baucus
Chairman
Subcommittee on Taxation and Debt
Management
Senate Finance Committee
Washington, D.C. 20510

Dear Senator Baucus,

The Yakima Indian Nation strongly endorses the S. 727 as previously passed by the Senate and HR 2792 as recently passed by the House, bills to clarify Indian fishing rights. The enactment of legislation clarifying the tax exempt status of income derived by Indians pursuant to treaty fishing rights is of extreme importance to our people.

The intent of this legislation is to make clear that income generated by Indian fishermen is to be exempt from tax if the rights of such Indians to fish are provided for, or secured by, any treaty or other provision of federal law.

The Yakima Indian Nation signed a Treaty with Governor Isaac Stevens in 1855 which guaranteed the right to continue to fish, both for subsistence and commercial purposes, in a tribally self-regulating manner. The Supreme Court has repeatedly ruled in favor of this tribally reserved right.

In opining on the question of the taxability of treaty fishing income Interior Secretary Don Hodel has written, "Indians who were parties to Stevens treaties understood that they would be able to continue fishing and trading fish without, in any way, having to turn over to the Federal Government a portion of their catch." The fishing resource itself is tantamount to a trust asset for these tribes and therefore should not be subject to taxation. In the case of Squire v. Capoeman, 351 U.S. 1 (1956), the principal case addressing taxation of Indian assets, the Supreme Court held that income generated from trust property is not subject to federal income tax.

The Capoeman case stemmed from the Court's interpretation of congressional intent in passing the General Allotment Act. The court held that income derived from the sale of natural resources on an allotment must be tax exempt to fulfill the purposes of the Act, specifically language in the Act stating that when an allotment passes out of trust and is transferred to the allottee or his/her heirs in fee, that it should be "free of all charge or encumbrance whatsoever." A 1906 amendment to this Act expressly removed "all restrictions as to ... taxation" of an allotment after the allottee received a fee patent.

Having concluded that the Act intended tax exemption during the trust period, the Court in Capoeman held that subsequently enacted federal income tax laws did not repeal or limit the exemption by implication. The Court stated, "To tax respondent under these circumstances would, in the words of the Court below, be, at the least, a sorry breach of faith with these Indians." Of further significance in this case was the Court's holding that the rules requiring liberal construction of Indian rights prevail

COLUMBIA HELICOPTERS, INC.

July 15, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
SH-203, Hart Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Michael A. Fahey
Vice President Finance/Treasurer

MAF/mdg

over the usual rules of tax law that exemptions should not be implied and are strictly constrained.

Further indications of Congressional intent that Indian income and assets should be treated uniquely can be found in the fact that Congress has always legislated that claims from Indian judgment funds were not taxable nor were distributions of tribal assets generated by tribal termination laws.

One of the major canons of Indian law is that Indian treaties should be interpreted in a manner in which Indians themselves would have understood them. Clearly, the imposition of an income tax on treaty fishing would be contrary to the Yakimas' understanding of the rights our forefathers reserved for themselves and future generations. This type of activity has never been taxed before and I would therefore urge the expeditious enactment of this legislation.

We believe however, that certain language in the "Relationship of Section to Treaties" provision of the House passed bill does violence to the concept of treaty reserved rights and should be changed in the Senate. In our Treaty of 1855, the Yakimas reserved all rights not granted to the United States, (see United States v. Winans, 198 U.S. 471, (1903)). This of course included the right to fish and the benefits flowing from that right. The bill and its report language as passed by the House infers that the United States government granted the fishery right to the tribes, rather than the tribes clearly having reserved that right. Similarly, this section of the House passed bill and even more so the report language, infers that it is this legislation and not the treaty that is the source of the tax immunity. It may be that the language in the bill ensures a tax exemption relative to what we hope will be language in the Internal Revenue Code but only in that the proposed language is clarifying in nature of the rights which we have always had; rights which reserved our authority to fish free of all encumbrance. The existing House language is simply incorrect in its statement of law. We do not ask for more than we are entitled to, and conversely should not have this bill change the status quo.

At a minimum, we would urge the Finance Committee to adopt the clarifying amendment and report language to this section as proposed by the Lummi Tribe as stated on page 7 of their testimony of July 12.

Thank you for taking the time to review this letter and I hope that your Committee will soon move to amend and report HR 2792 to the Senate.

Sincerely,

Yakima Tribal Council

Levi George

Levi George
Chairman
Fish and Wildlife Committee

Statement of the Confederated Tribes of the Umatilla Indian Reservation, Oregon, before the Senate Finance Committee, Subcommittee on Taxation and Debt Management on H.R. 2792

Submitted July 21, 1988

The Confederated Tribes of the Umatilla Indian Reservation has reviewed H.R. 2792 as submitted to the Senate Finance Committee and we support its enactment for the following reasons.

On June 9, 1855, the Walla Walla, Cayuse and Umatilla Tribes (hereinafter the Confederated Tribes of the Umatilla Indian Reservation) signed a treaty with the United States which ceded a vast territory of land in exchange for several reserved rights. Among other things, the Confederated Tribes reserved the right to maintain their own form of government, the right to make and enforce laws within their territorial jurisdiction, and the right of taking fish both in the streams running through and bordering the reservation as well as at all other usual and accustomed stations off reservation.

The federal laws establishing a federal income tax were enacted after the Treaty of 1855 was negotiated with the Confederated Tribes. Clearly, at the time the treaty was negotiated, the treaty Indians did not bargain for an encumbrance on their treaty fishing activities in the form of a federal tax. We believe that an imposition of a federal tax on our treaty fishing activities would be tantamount to an abrogation of a right reserved to us by treaty. H.R. 2792 is an important clarification of the tax exempt status of income derived from the exercise of treaty fishing rights.

We understand that some questions have arisen about the interpretation that is to be given to Section 1(C) (3) of H.R. 2792. This section reads:

> "The provisions of any law, Executive order, or treaty which secure any fishing right for any Indian tribe shall not be construed to provide an exemption from any tax imposed by this title which is broader that the exemption recognized by this section."

We believe that both the Report on H.R. 2792 from the House Committee on Ways and Means, as well as Senator Inouye's testimony before the Senate Finance Committee on July 12, 1988, provide the proper interpretation of this section. H.R. 2792 would be the definitive statement of Congress on the question of tax treatment of Indian fishing rights income; no other type of tax exemption can be claimed for Indian treaty fishing income except as provided for in H.R. 2792; and H.R. 2792 governs only tax treatment of income derived from the exercise of treaty reserved fishing rights and no inference should be made that income derived from treaty activities unrelated to fishing activities is or is not exempt from taxation.

Thank you for the opportunity to submit this statement for the hearing record. We are available to clarify out statement if the need arises.

Edward H. Zeller
201 Sugar St.
Newtown, Ct. 06470

July 22, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Ms. Wilcox:

This letter is to urge simplification of Section 89 administrative rules. My employer, Danbury Hospital supports non-discrimination, but as a not-for-profit community hospital, cannot bear the burden of the time and money required for compliance under the proposed rules.

Health care is in the midst of heated competition for health care professionals, most of whom are women, and many of whom work part-time because of family obligations. To meet their special needs, my hospital offers great flexibility in its benefit programs and plans for further flexibility in the health plan. The hospital's three current health plans, including a required HMO, become 27 plans to be tested separately under the proposed Section 89 rules.

By exercising their legitimate choices, the covered people themselves may be creating "discrimination" conditions and jeopardizing the non-taxability of the benefits of others. The hospital and its staff will be penalized for the very choices so highly promoted and desperately needed by the growing number of career women in the workforce.

It will cost my hospital thousands of dollars to buy the necessary computer programs and thousands more every year in manpower and computer time to track Section 89 requirements. Further, Section 89 compliance will deny us the flexibility to develop innovative compensation packages which in the future will be the foundation for recruitment into the field of high quality patient care.

On behalf of Danbury Hospital, I urge you to reduce the complexity of the definitions and the analysis required, to acknowledge the special needs of female employees, and to require compliance at the beginning of each plan year rather than daily. Better yet, set appropriate standards for plan design and eliminate testing. Non-discrimination goals can still be achieved, but the cost burden to employers and unfair tax jeopardy to employees will no longer be an issue.

Respectfully,

Edward H. Zeller

Edward H. Zeller
Vice President, Human Resources
of the Danbury Hospital

EHZ/kt

STATEMENT OF
THE EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) appreciates the opportunity to submit this statement to the Committee on Finance for the record of its hearing of July 13, 1988 concerning certain provisions contained in H.R. 4333, the Technical Corrections Act of 1988, as adopted by the House Committee on Ways and Means.

EEI is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. They generate approximately 76 percent of all electricity in the country and provide electric service to 73 percent of all ultimate customers in the nation.

This statement focuses on only one provision being considered by the Ways and Means Committee: the intercorporate dividends received deduction.

PROPOSAL TO CHANGE THE DIVIDENDS RECEIVED DEDUCTION

Under present law, in determining taxable income, corporations owning less than 20 percent of the stock of another corporation (so-called portfolio investments) are entitled to a deduction equal to 70 percent of the dividends received from such corporations. The current proposal, regarding the dividends received provision for portfolio investments, would lower the percentage deduction to 55 percent in 1989, to 52.5 percent in 1990, and to 50 percent in 1991 and thereafter, as well as changing the current portfolio threshold level from less than 20 percent to 20 percent or less.

EEI POSITION

The investor-owned electric utility industry opposes any proposal that would result in higher costs of providing utility services, thereby increasing rates for our electricity customers. As the most capital-intensive industry in the nation, electric utilities must often enter financial markets to secure funds for plant and equipment, operations and refundings. As discussed below, the proposed change to the taxation of dividends will adversely impact electric utility customers.

INCREASED COST OF CAPITAL

Typically, the financial structure of an investor-owned electric utility reflects approximately 50 percent equity and 50 percent debt. The equity component generally is distributed between common stock and preferred stock. Currently, the industry has outstanding $28 billion in preferred stock and $91 billion in common stock as reported in company balance sheets.

The proposed reduction in the dividends received deduction will cause a disruption in the ability of electric utilities to obtain reasonably priced capital. It would reduce the after-tax yield to corporate investors in utility stocks, and, as a result, increase the cost of this form of financing. Increased capital costs are a component of the cost of electricity, and are, thus, usually borne by customers.

Traditionally, electric utilities have relied on preferred stock as a vital form of financing. According to the Alliance for Capital Formation, more than one-half of all publicly-traded outstanding preferred stock has been issued by utilities. Because of the reduction in yield, utility issuers of preferred stock could be forced to increase the dividend rate by approximately 7 percent in order to provide the same after-tax yield to investors. Since cost of capital is a component of utility rates, this increase will usually result in an increased cost of electricity to customers.

Furthermore, some of the already-issued fixed rate preferred stock is subject to a gross-up provision which is contained in the covenants of the preferred stock. Thus, should the tax law change so that the after-tax return to the investor is reduced, the issuing utility would be required to increase the pre-tax yield so that the after-tax yield to the investor is the same as when the preferred was issued. These increased costs also would be passed to electricity customers.

As the cost of this form of financing increases, utilities that might have financed with stock may issue debt as an alternative. As utilities replace stock with debt, corporate tax revenues to the Treasury would be decreased since interest on debt is deductible at a 34 percent tax rate by the paying corporation with a maximum tax rate of 34 percent by the receiving corporation. Dividends currently provide revenue to the Treasury both by their nondeductibility to the distributing corporation, their partial taxability to the receiving corporate taxpayer and the full taxation of dividends received by individuals.

Moreover, the marketability of common stock issues of electric utilities, unlike the issues of many other corporations, is highly sensitive to changes in effective yields. Therefore, the proposed reduction could result in a diminishment in the corporate market for electric utility common and preferred stock, further impairing the ability of the industry to raise needed capital at a reasonable cost. As discussed before, these increased costs are borne by the customers.

Additionally, shareholders, many of whom are retired and dependent on dividends for income, will suffer a loss of stock value. This will occur because the market price of stocks will decrease in order to adjust the after-tax yield to that demanded by the market prior to the reduction in the dividends received deduction.

MULTIPLE TAXATION

Historically, the federal income tax law has provided for the taxation of income at the distributing corporation level and again at the eventual individual shareholder level. The dividends received deduction was conceived to essentially eliminate taxation on the same dividend income for the corporate investor at the intermediate level(s). Failure to provide an adequate and reasonable dividends received deduction for dividend income received by an intermediate corporation(s) will result in effectively levying a triple or greater tax on the same income. This would appear to violate a basic tenet in federal taxation and produces poor tax policy.

CONCLUSION

Since 1982, federal tax legislation has significantly eroded the ability of electric utilities to obtain reasonably-priced capital. Recent tax changes have reduced many capital formation incentives including the loss of the investment tax credit, the elimination of the current deduction for construction-period interest and the reduction of accelerated depreciation. The further reduction of the dividends received deduction represents continued erosion of capital formation mechanisms and additional capital costs for utility customers.

EEI recognizes the stated goal of the tax writing Committees of Congress to present a revenue neutral technical corrections bill. However, we do not believe that the proposed reduction in the dividends received deduction should be used to offset the revenue losses associated with other proposals contained in the Technical Corrections Act of 1988.

esi

Electro Scientific Industries, Inc.
13900 NW Science Park Drive
Portland, Oregon 97229-5497
(503) 641-4141 • Telex: 474-2064

July 22, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain, and has no operational use once gathered. The data gathering and testing will lead to increased plan expenses at a time when Electro Scientific Industries (ESI) is attempting to remove costs, which do not add employee value, from its benefit plans.

Section 89 requirements place the burden of proving non-discrimination on sponsors, such as ESI, whose plans are already non-discriminatory and benevolent in design, while adding no perceivable service to individual plan participants.

The incredibly complex rules as yet have no final regulations for compliance. Yet employers are facing compliance on January 1, 1989. Even if final regulations are issued immediately, there is probably not time to apply the complex tests and demonstrate compliance by January 1989.

Electro Scientific Industries, Inc., believes that its mission certainly includes being a positive, contributing member of the American community and the local communities in which it does business. We believe that being competitive and profitable in our domestic and foreign markets contributes to this profitable and productive presence.

Because we have been and continue to be a benevolent employer, sponsoring an array of employee benefits, ESI will be heavily impacted by these demands. Each legislated demand for "data for data's sake" inflates our cost structure, and erodes our competitiveness in markets where our competitors are not similarly burdened.

On behalf of ESI and our employees I urge you to:

- Repeal Section 89, or,
- Delay Section 89's data requirements until at least one year after issuance of final Treasury regulations, or,
- Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues, the plight of Electro Scientific Industries, and other plan sponsors is appreciated.

Sincerely,

Bill Karns
Manager, Human Resources

The Employee
Welfare
Trust
WASHINGTON BANKERS ASSOCIATION

2001 Sixth Avenue
Suite 1717
Seattle, WA 98121

(206) 728-5880

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data-gathering and administrative burden on plan sponsors. Much, if not most of the data required is difficult to obtain and will not be used for any other purpose. Data-gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination in agreeable; however, the section 89 rules are too complicated and the cost of gathering and maintaining data is staggering.

As the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

Please provide a measure of relief to plan sponsors by considering the following alternatives:

* Repealing Section 89;
* Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
* Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Barbara Dahl, Director
Employee Welfare Trust

Equicor-Equitable HCA Corporation
520 Pike Street
Suite 1515
Seattle, WA 98101
(206) 621-1090

July 20, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Bob

Robert H. Johnston
Senior Group Representative

WRITTEN TESTIMONY PRESENTED TO THE
COMMITTEE ON FINANCE, UNITED STATES SENATE
ON THE DIVIDENDS RECEIVED DEDUCTION
IN CONNECTION WITH A HEARING ON JULY 13, 1988
REGARDING PROVISIONS THAT MAY BE ADDED TO THE
TECHNICAL CORRECTIONS ACT OF 1988 (S. 2238)
SUBMITTED BY IVINS, PHILLIPS & BARKER,
ON BEHALF OF THE FAMILY HOLDING COMPANY GROUP

We represent the Family Holding Companies Group, a newly-organized group of family investment companies. The group includes mostly personal holding companies ("PHCs"). Many of the members have substantial "portfolio" stock investments (i.e., investments in less than 20 percent of the stock of another corporation).

Personal holding companies are subject to the penalty tax scheme of Code Sections 541 through 547. Essentially, the penalty tax requires that all dividends received by a PHC on portfolio stock investments be passed through in the same year to the PHC's shareholders to avoid the PHC penalty tax. The penalty tax is imposed at a 28 percent rate. It is designed to prevent the accumulation of investment income at the PHC level and is set at a rate to mimic the shareholder level tax.

Therefore, all dividends received by a PHC bear at least twofold federal income taxes: a corporate income tax at the payor level (i.e. the tax paid by a General Motors company whose stock is owned by the PHC) and an individual shareholder tax when the amount is distributed by the PHC (or the same amount of PHC penalty tax if not distributed). To the extent dividends paid to a PHC are not protected by the dividends received deduction ("DRD") they bear a third tax -- a 34 percent corporate levy at the PHC level. The DRD, permitting a partial exclusion of dividends received from the third tax imposed on PHCs, was 85 percent for fifty years prior to 1987, 80 percent in 1987, and, under current law, is set at 70 percent.

The Ways and Means Committee has now voted to phase down the DRD from 70 percent to 50 percent (over three years) for recipient corporate shareholders owning portfolio stock. This would be an enormous 67 percent increase in tax on such intercorporate dividends (an increase from 10.2 percent [34% x 30%] to 17 percent [34% x 50%]).

The Family Holding Companies Group opposes any reduction in the DRD for portfolio dividends. Unless the DRD is retained at 70 percent or the exemption is provided, the already indefensible third tax on the same corporate earnings will be increased by two-thirds.

If, however, revenue pressures require a reduction in the DRD for portfolio dividends, the Family Holding Companies Group proposes an exception for portfolio dividends received by PHCs in which the dividends are either subject to the PHC penalty tax or are distributed to shareholders. The DRD for such dividends should be no lower than 70 percent.

Alternatively, an exception for dividends passed through any corporation could be created regardless of whether or not the recipient was a PHC. To avoid the complexity of tracing the source of dividends paid out by a non-PHC corporation claiming a DRD (since such non-PHC corporation will not be forced by the PHC penalty tax to distribute all dividends it receives), each dollar distributed as a dividend could be deemed to be comprised, pro rata, of income from each source earned by the corporation in that year.

There is no policy justification for any amount of triple tax on the same corporate earnings. Most developed countries are moving toward the elimination of a double tax on corporate earnings. Most economists and other fiscal experts agree that the United States should follow these integration systems to avoid double taxation on corporate profits. Even under our corporate tax regime, a separate level of taxation is appropriate only where the recipient of income can consume or reinvest the income. The first corporate payor can reinvest or distribute the income it earns in its operations, so the initial corporate tax may be justified on that basis. The distributee individual shareholder can reinvest or consume the amount dividended to him; again, a possible justification for a separate level of tax. This dual taxation, once at the corporate level and once again at the shareholder level is the paradigm of the U.S. system of taxation for corporate earnings. An intervening personal holding company, however, must distribute the dividends it receives; if it does not, it will be subject to a penalty tax that effectively replicates the shareholder level tax. There is, therefore, no justification for another layer of tax on the dividends received by such a corporation where a corporation passes through the dividends it receives to its shareholders in the same taxable year it receives them.

Historically, the U.S. tax regime has provided for the double taxation of corporate earnings but, generally, has never provided a policy justification for more than two levels of tax. The small existing triple tax (on the 15 percent, now 30 percent of dividends not subject to the DRD) is an historical anomaly. Its real policy function was eliminated twenty years ago.

A 100 percent DRD existed for all intercorporate dividends from 1909 until 1935. A reduction in the DRD to 90 percent in 1935 (85 percent in 1936) was made in tandem with the introduction of graduated corporate rates. The lower rate was intended solely for small business. (Using the lower rate was known as obtaining a "surtax exemption," since the higher rate was known as a surtax.) Solely to prevent large corporations from dividing into many separate smaller corporations to take advantage of the lower bracket (known as obtaining "multiple surtax exemptions") the DRD was reduced for all dividends paid to corporation shareholders so that intercorporate dividends (the payment of profits from the separate smaller corporations to the parent) would bear a partial second corporate tax. See H. R. Report No. 1681, 74th Cong., 1st Sess., 3 (1935) (President Roosevelt's message to Congress). This reduction in the DRD from 100 percent in no way signaled a policy decision that corporate earnings should be subjected to multiple taxation as they are passed through a chain of corporations. The policy served was solely to discourage the use of holding companies to obtain the lower rate of taxation which was intended solely for small businesses.

The reduced DRD failed to serve fully its intended function of discouraging multiple surtax exemption use, however. In 1964, after years of effort, Congress offered an incentive to further attack the surtax exemption problem. It restored the 100 percent DRD for members of an affiliated group that waived multiple surtax exemptions. This was intended to encourage a group to trade multiple surtax exemptions for a better dividends received deduction. This incentive approach was not fully successful. Finally, the Tax Reform Act of 1969 abolished multiple surtax exemptions for affiliated groups. In the process, however, the 85 percent dividends received deduction, reduced from 100 percent solely to address the multiple surtax exemption problem, remained untouched. As one law professor has commented, "the continuation of the tax for unaffiliated groups [after the 1969 Act] is, however, a puzzle. The answer may be that the tax was left in place simply because no voice was raised against it." Schaffer, "Intercorporate Dividends," 33 Tax Lawyer 161, 176 (1979). A small amount of triple taxation, therefore, was preserved even though the purpose of the triple taxation had been removed, apparently because no voice was raised against this small amount of triple taxation.

In the 1986 Act, the 85 percent DRD was reduced to 80 percent for the first time in fifty years. This was to reflect the lower tax rates under the 1986 Act -- that is, to retain approximately the same total level of triple taxation.

In the Revenue Act of 1987 the DRD was consciously reduced to 70 percent as a revenue raising measure. For the first time, a distinction was made between "portfolio dividends" and non-portfolio dividends. The rationale, while not well thought out, appears to be that a corporate shareholder, unless it owns substantial stock in another corporation, should be treated the same as any other investor. As the history related above makes clear, however, this rationale runs directly counter to 80 years of corporate taxation policy. It also runs counter to international trends in corporate taxation which, through corporate/shareholder taxation integration, attempt not to impose third levels of taxes on corporate earnings but to eliminate the second level of taxation on corporate earnings.

The Treasury Department, in connection with the Finance Committee's Subchapter C study, testified on October 24, 1983 in support of a link between the dividends received deduction and the distribution of the dividends received in the form of a dividend paid by the corporate recipient. In essence, Treasury proposed the elimination of multiple levels of corporate taxation on dividends that are neither consumed nor reinvested at a corporate recipient level but are "passed through" to a corporation's shareholders. A 100 percent dividends received deduction would be appropriate, therefore, for personal holding companies which must pass through dividends received to their shareholders to avoid the penalty tax.

The only criticisms that have been leveled against the DRD for portfolio dividends (see the ALI Subchapter C Reporter's study on intercorporate investments) pointedly do not apply where the corporate recipient of the dividends is compelled to distribute those earnings to its own shareholders (compare the ALI Reporter's comments on the DRD and regulated investment companies). Indeed, the rationale that a corporation should be treated the same as any other investor applies only if the corporation may use its investment earnings the same as another investor, i.e., may consume or reinvest those proceeds.

A specific exemption for personal holding companies or other corporations that act as investment pass through entities is not without precedent in existing tax law. Mutual funds, regulated investment companies, real estate investment trusts and certain S corporations function similarly to family holding companies. They, of course, are permitted virtually a complete flow through of earnings so that there is only double taxation of corporate dividends, not triple taxation. Particularly since any tax advantage to a personal holding company, if not entirely eliminated by the personal holding company penalty tax, has certainly been eliminated by the lowering, for the first time in history, of the maximum individual rate to a level below the maximum corporate rate. Similar flow through treatment, at least with respect to corporate dividends, is appropriate for PHCs.

Triple tax on corporate dividends may also have a pernicious effect on equity markets, already troubled by what might be characterized as overly speculative behavior in the takeover-prone 1980s. Family holding companies tend to be long-term holders of corporate equities. A triple tax on corporate dividends received, however, will encourage family holding companies to avoid equity investments and shift their investments to tax-exempt bonds. The removal of family holding companies from the stock market could have not only a depressive effect on the market but may also remove a stabilizing influence.

The revenue effect of an exclusion from further reductions in the portfolio DRD for personal holding companies is, at present, being computed by former government revenue estimators at Peat, Marwick. Peat, Marwick will make its data available to the Joint Committee revenue estimators and explain its methodology at arriving at the cost of the proposed exemption as soon as it has collected sufficient data to compute a trustworthy revenue estimate for a PHC exclusion.

July 21, 1988

FLOATING POINT
SYSTEMS, INC.

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D. C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simmplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

FLOATING POINT SYSTEMS, INC.

Nancy Andrews,
Director of Human Resources

su:7

forest grove

July 19, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

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Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Barbara Huson

Barbara Huson
Human Resource Services Manager

GENERAL
HOSPITAL
MEDICAL CENTER

July 21, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data-gathering and administrative burden on plan sponsors. Much, if not most of the data required is difficult to obtain and will not be used for any other purpose. Data-gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

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14th and Colby, P.O. Box 1147, Everett, Washington 98206-1147, (206) 258-6300

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
July 21, 1988
Page 2

In order to provide a measure of relief to plan sponsors-especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

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Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Russ Keefer/lf
Russ Keefer
Assistant Administrator/Human Resources

RK:lf

3699t

SUBMISSION BY JACK N. WARREN IN RE TECHNICAL CORRECTIONS ACT OF 1988

(July 13, 1988)

CLARIFICATION IN SEC. 382 TRANSITIONAL RULE IN 1986 ACT

The Committee is respectfully requested to give consideration to a technical clarification in Subparagraph (D) Sec. 621(f)(2) of the 1986 Act, a SEC. 382 TRANSITIONAL RULE. The rule provides:

> "(D) Special Rule For Oil and Gas Drilling Business.--In the case of a Texas corporation incorporated on July 23, 1935, in applying section 382 of the Internal Revenue Code of 1986 (as in effect before and after the amendments made by subsections (a), (b) and (c) to a loan restructuring agreement during 1985, section 382(a)(5)(C) of the Internal Revenue Code of 1954 (as added by the amendments made by subsections (e) and (f) of Section 806 of the Tax Reform Act of 1976) shall be applied as if it were in effect with respect to such restructuring or reorganization."

BACKGROUND: Goldrus Drilling Company, Inc. ("Goldrus") is a service company engaged since 1935 in drilling oil and gas wells. After a period of net operating losses (during the recent downturn of the oil industry), Goldrus entered into a loan restructuring agreement with its secured bank creditors (the "Bank Group") in 1985. As a part thereof, the Bank Group agreed to convert Goldrus debt of $15,857,054 into warrants, rather than stock itself, for 80% of Goldrus common stock, since the Bank Group did not want formal ownership of the stock. The relationship of the Bank Group to 80% of Goldrus common, (i.e. possession available upon call and payment of the nominal sum of $80), is essentially the same as that of a grantor of the corpus of a revocable trust.

Sec. 382 limits use of loss carryovers (NOLs) where there is a change of ownership of a loss corporation, with certain exceptions. The Tax Reform Act of 1976 revision of Sec. 382 provided an exception for a stock purchase or acquisition by an exchange of debt-for-stock by a bona fide creditor (recognizing that such exchanges do not involve trafficking in loss corporations). The 1976 revision, after a series of effective date postponements, was repealed in connection with the 1986 revision. New Sec. 382(1)(5) provides a similar change of ownership exception for creditor exchanges of debt-for-stock in a title 11 or similar proceeding.

TRANSITIONAL RULE PROVIDED. In Sec. 621(f)(2) of 1986 Act Congress provided, in response to Goldrus' request, a limited transitional rule permitting application to its 1985 debt restructure of the exception in the 1976 Revision for exchanges of debt-for-stock by bona fide creditors.

PROBLEM WITH TRANSITIONAL RULE. The Bank Group received warrants (which have never been exercised), rather than stock, for their claims against Goldrus. Old Sec. 382 provides for application of Sec. 318 attribution rules, so that the Bank Group, as holder of warrants, is treated as constructive owner of 80% of Goldrus common stock. The transition rule in Sec. 621(f)(2), in combination with Sec. 318 attribution rules, treats stock subject to warrants as constructively owned by the Bank Group, and as qualifying for the 1976 Revision exception for creditor exchanges of debt-for-stock.

Unfortunately, the 1986 revision of Sec. 382 modifies Sec. 318 attribution rules so that stock subject to a warrant is attributed to the holder only if this results in a change in ownership. Counsel advises that in view of this and the language of the transitional rule in applying the exception in the 1976 revision, there is an uncertainty as to whether stock subject to the Bank Group's warrants is treated as outstanding in 1985 and subsequent years after application of the transitional rule. If not treated as outstanding, there may be an unintended disqualifying change of ownership due to inconsistent treatment of stock subject to such warrants.

TECHNICAL CORRECTION: Goldrus urges that the transitional rule in Sec. 621(f)(2) of the 1986 Act be amended to clarify that stock subject to warrants issued in such loan restructuring shall be deemed to be outstanding during the period such warrants are outstanding. Such clarification will carry out the intended purpose of Sec. 521(f)(2) of the 1986 Act. Although the Staff has responsibility for drafting statutory language to implement the Committee's decision, the following is suggested as a guide:

> "Subparagraph (D) of Sec. 621(f)(2) of the Tax Reform Act of 1986 is amended by deleting the period at the end thereof, substituting a comma, and adding the following: 'and stock subject to warrants issued pursuant to such loan restructuring agreement shall be deemed to be outstanding stock of such corporation during the period such warrants are outstanding.'"

REVENUE COST: Since the proposed amendment merely clarifies a transition rule in the 1986 Act, limited to a single corporation, there should be no revenue cost.

SUBMISSION BY THE HON. MIKE GRAVEL July 11, 1988

TECHNICAL CORRECTION OF UNUSUAL EFFECTIVE DATE PROVISION IN 1986 ACT

The Committee is respectfully requested to give consideration to a technical amendment to CORRECT AN UNUSUAL EFFECTIVE DATE PROVISION, which is found in Sec. 621(f)(5) of the 1986 Act.

As the Committee is well aware, changes in tax law normally apply to all transactions after date of enactment (or date of Committee action or Treasury Announcement in some cases). In cases where taxpayers have made commitments in reliance on Old Law, Congress may make Old Law applicable, but if general desirability of Old Law is unclear, and Congress wishes to help those acting in reliance on old law, it will make old law elective with them, with others subject to general effective date.

The background: Sec. 382 limitations on use of NOLs and credit carryovers (both Old Law and 1986 Act) are triggered by disqualifying changes in ownership of a loss corporation. The general effective date of 1986-Sec. 382 is a disqualifying ownership change following a purchase after December 31, 1986, or following a reorganization where plan is adopted after December 31, 1986.

A special effective date is provided in Sec. 621(f)(5), i.e. Old Law is to apply where an ownership change results from a reorganization plan or exchange of debt-for-stock after 1986 in a title 11 case if a petition was filed before Aug. 14, 1986. But for this exception, the general effective date would apply New Sec. 382 in the case of a petition under title 11 filed before Aug. 14, 1986, where the ownership change occurs pursuant to purchases, or a reorganization plan adopted, after 12/31/86.

In drafting the special effective date, Legislative Staff apparently believed that Old Sec. 382 was more favorable to taxpayers than New 382, and that Ch. 11 filings were made in reliance on existing tax law.

Old Sec. 382 was more favorable than New Sec. 382 to corporations in title 11, in view of New Sec. 382's reduction in NOLs by interest payments to creditors and by one-half of excluded debt-discharge income. However, New Sec. 382 provides a certainty in planning to qualify, not available under Old Sec. 382. To some taxpayers the reduction in NOLs is a reasonable cost or toll charge to pay for the additional certainty in planning a title 11 reorganization which meets requirements of Sec. 382.

While in some cases taxpayers may be acting in reliance on existing law in filing petitions in bankruptcy, this can hardly be the case where economic necessity compels such filings. Or in cases where although the timing of filing a petition is within control of the shareholders, the creditors thereafter dominate (via court appointee) the reorganization.

To summarize: Although in some title 11 cases Old Sec. 382 may be regarded as more desirable than New Sec. 382 and there may be reliance thereon in filing a petition in title 11 (as assumed by Staff), there clearly are other title 11 cases in which filing in bankruptcy is an economic necessity not involving reliance on existing tax law, since there is no alternative. And there will be cases in which the greater certainty of New Sec. 382 (even at cost of reduced NOLs) is regarded as preferable to Old Sec. 382. Sec. 621(f)(5) of 1986 Act fails to take into account the latter two cases.

Technical Correction: Consistent with the normal legislative practice governing effective dates of tax amendments, it is submitted that if Congress intended to help those title 11 corporations who acted in reliance on old Sec. 382, the special effective date provision, Sec. 621(f)(5), should have been limited to those title 11 corporations filing a petition before August 14, 1986, who elected to have Old Sec. 382 apply. This would leave other title 11 corporations subject to the general effective date of Sec. 382. Accordingly, it is urged that Sec. 621(f)(5) of the 1986 Act be amended to make its application conditional on taxpayer making an election thereunder. For example:

> "Paragraph 5 of section 621(f) of the Tax Reform Act of 1986 is amended by deleting the period at the end thereof and substituting the following: ', and if the taxpayer elects to have the provisions of this paragraph apply.'"

Alternatively, if it is desired to place the burden of election on the taxpayer desiring the general effective date:

> "Paragraph 5 of section 621(f) of the Tax Reform Act of 1986 is amended by deleting the period at the end thereof and substituting the following: ', unless the taxpayer elects to have the amendments made by subsections (a), (b), and (c) apply to any such ownership change.'"

Revenue Cost Should be Negligible. It is assumed there will be some title 11 corporations which will not attempt to qualify for loss carryovers, in the absence of the certainty provided by New Sec. 382, but that there will be other title 11 corporations (preferring the certainty of New Sec. 382, even with reduced NOLs), who will claim the greater NOLs under Old Sec. 382 if New Sec. 382 is not available. It is not unreasonable to anticipate that the increase in tax saving by corporations claiming reduced tax savings under New Sec. 382 will be offset by the tax savings foregone by a smaller number of corporations who would pursue NOLs under Old Sec. 382 if New Sec. 382 is not available. Hence, revenue cost of the technical correction should be negligible.

Committee on Finance
United States Senate
Statement of the Greater Cleveland Domed Stadium Corporation
for Submission and Inclusion
in the Printed Record of
the Committee on Finance Hearing held on
Wednesday, July 13, 1988 at 10:00 a.m.
Concerning Tax Issues

The Greater Cleveland Domed Stadium Corporation is an Ohio nonprofit corporation, established by representatives of the Governor and General Assembly of Ohio, the Mayor of the City of Cleveland and other city and local government officials in the Greater Cleveland area, and representatives of the private sector, for the purpose of financing and constructing a new stadium intended primarily to house, and to retain in Cleveland, the professional baseball and football franchises that are now located there. Since the Corporation's request to testify at your July 13, 1988 hearing on proposed tax law changes was not granted, the Corporation takes this opportunity to submit its comments in writing.

The proposed stadium project is already the subject of subparagraph (A) of Section 1317(3) of the Tax Reform Act of 1986 (the "Act"), which authorizes the issuance of up to $200 million of tax-exempt "exempt facility" bonds. That provision now describes the project to be financed as a "domed stadium," but H.B. 4333, The Miscellaneous Revenue Act of 1988, would eliminate the word "domed" in describing the kind of stadium that may be financed under that transition provision. The Corporation requests that, in addition to that change, subparagraph (A) of Section 1317(3) of the Act be amended so as to include an arena, in addition to the stadium, as a facility that could be financed from the proceeds of the amount of bonds authorized under that subparagraph. Such a provision was included as Section 10213(g)(3)(B) of the technical corrections portion of the Revenue Act of 1987 as passed by the House of Representatives on October 29, 1987, but then omitted from that bill, along with all of the other proposed technical corrections, in the Conference Committee before final passage of that Bill. The effect of that provision would have been to amend the existing transition provision in Section 1317(3)(A) of the Act to substitute for the language "a domed stadium" the words "one or both of a stadium, whether open or covered, and an arena in or adjacent to the proposed site of the stadium, and as to the stadium-". No change would have been made, nor is any change requested, in the amount ($200 million) of bonds that could be issued for the purpose of financing costs of the facility. The Corporation has acquired and now owns the land in downtown Cleveland that will be the site of the new stadium and that also could accommodate an arena.

While it was the expectation of the Corporation - and of the various constituencies in Greater Cleveland and the State of Ohio that it represents -- at the time that the transition rule in the Act was enacted to construct a stadium that would be covered by a roof during at least a part of each year, it was not at the request or suggestion of the Corporation that the transition provision be limited to a "domed" stadium. In its other undertakings and agreements, the Corporation has attempted to maintain flexibility as to whether the stadium would be covered or not, but the drafters of the existing transition provision, responding to information that was provided to them most of which referred to the expectation at the time that the stadium would be covered, included the word "domed" to describe the stadium.

As the Corporation has proceeded with planning and design activities for the stadium, representatives of the major-league baseball and football teams located in Cleveland have stated a current preference for an open stadium. The Corporation is, therefore, appreciative of the fact that the requested change eliminating the word "domed" from the existing transition provision is included in the technical corrections portion of the pending Miscellaneous Revenue Act of 1988, and urges retention of that provision in that Bill.

Central to the Corporation's function in attempting to finance and construct a new sports facility or facilities in downtown Cleveland, and to the determination by the Internal Revenue Service of the Corporation's charitable status under Section 501(c)(3) of the Internal Revenue Code, is the economic revitalization of the Greater Cleveland area that will be supported and enhanced by the development of a needed sports facility or facilities. The Corporation has acquired approximately 28 acres of land at a location in downtown Cleveland as the site of the proposed facility and has begun the process of demolition of structures on that site, most of which were determined by the City of Cleveland to be blighted. The site is sufficiently large and its location is such as to be suitable for the construction of a sports arena as well as a multi-purpose stadium of sufficient size to accommodate professional football and baseball games. Based on cost estimates for the construction of a stadium that the Corporation has received from its expert consultants and contractors, it appears that an open-air stadium could be constructed for an amount substantially less than the $200 million of exempt facility bonds authorized by the existing transition provision. That difference in cost could, if the requested amendment is approved, be applied to the cost of construction of an adjacent arena without increasing the principal amount of the bonds already permitted to be issued.

One of the important considerations leading to the initial plan for a covered stadium was the expectation that such a facility, because of its ability to attract a larger number of events than just professional sports, would have a significantly greater impact on the creation of jobs and economic development in the Greater Cleveland area than would be the case with an open-air facility. Should it be the case, however, that the expressed desires of the professional sports teams and economic and other considerations result in the determination that an open-air stadium should be constructed, the construction of a smaller enclosed sports arena that could accommodate additional events could be expected to produce many of the hoped-for job creation and economic development benefits that the Corporation was established to provide. The Corporation continues to believe, on the basis of the best information and advice available to it, that the availability of the lower-cost financing for the project that tax-exempt bonds can provide will probably be a critical element in the ability of the community to provide either or both of a stadium and an arena.

As recent events in a number of cities involving relocations or proposed relocations of professional sports franchises have shown, suitable facilities are often an important, even critical, factor in determining whether a community will be able to retain or attract professional sports franchises with the attendant economic benefits that such franchises bring to a community. The Weatherhead School of Management of Case Western Reserve University estimated in 1985 that the location and operation of the professional football and baseball teams in Cleveland results annually in a minimum of $50 million of economic activity in the Greater Cleveland area. The Corporation believes that the construction of a new stadium may be critical to the retention of those teams and that the construction of an enclosed arena in conjunction with the stadium would contribute significantly to the redevelopment of an important area of downtown Cleveland, to further ancillary development of hotels, parking and restaurant facilities and to the creation of jobs in connection with these and other enterprises, all of which would contribute in a very significant way to the continuing revitalization of downtown Cleveland and the benefits that that will bring to the entire Greater Cleveland community.

As stated above, the Corporation is not requesting authorization for the issuance of any greater amount of bonds than is already provided for in current law. The requested change would simply provide for the Corporation, and the public-private partnership involving the State of Ohio, the City of Cleveland and other local governments, business organizations and other private persons and organizations that it represents, with the needed flexibility to determine what kind or kinds of new sports facilities will best serve the needs of Greater Cleveland.

We appreciate this opportunity to present this request and statement to your Committee. The representatives of the Corporation listed below will be glad to respond to any requests for information that you may wish to make.

Respectfully submitted,

Thomas M. Lynch

Thomas M. Lynch, Executive Director

Eugene L. Kramer, Counsel for
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July 19, 1988

Ms. Laura Wilcox, Hearing Administrator
US Senate Committee on Finance
SD-205, Dirksen Senate Office Bldg.
Washington, DC 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expense -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of nondiscrimination is laudable, but the resultant Section 89 nondiscrimination rules are overwhelming. Is is really necessary to use such a complicated and detailed method to prove nondiscrimination?

Although there is a slightly easier "alternate coverage test," because of it's design, it will not be available except to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is nondiscriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will become effective.

page 2, cont.
July 19, 1988

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are not in a position where they have to provide their nondiscrimination according to nearly incomprehensible standards, I would request your consideration of one or more of the following alternatives:

1) Repealing Section 89;

2) Delaying Section 89's effective date to at least a year after Treasury issues final regulations;

3) Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

HALL LABORATORIES, INC.

Andrew M. Pinkowski
Chairman of the Board

AMP:pra

HOAG MEMORIAL HOSPITAL PRESBYTERIAN
301 NEWPORT BOULEVARD • BOX Y • NEWPORT BEACH, CALIFORNIA 92658-8912 • PHONE (714) 645-8600

July 19, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen, Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

I would like to make some comments for the record of the hearing on the Technical Corrections to Section 89 held on July 13, 1988.

While I do recognize Section 89's goal of non-discrimination, I would prefer the rules and tests be simpler and more workable. Also I would like to recommend that the regulations be complete and thorough, not leaving important questions unanswered. Also employers need to be given more lead time in completing the tests and implementing the law.

Lastly, it must be realized that employers will be faced with spending a significant amount of dollars to hire extra personnel to gather the data, run the necessary tests on all plans, and to support the program on an on-going basis. It is expecting too much of U.S. employers to outlay funds for these kinds of activities. COBRA was bad enough.

Sincerely,

Ann C King

Ann C. King
Benefits Manager

AK/ac

A Non-Profit Community Hospital Accredited by the Joint Commission on Accreditation of Hospitals

HOOKER & HOLCOMBE, INC.

BENEFIT CONSULTANTS AND ACTUARIES

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July 13, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
SH-203, Hart Senate Office Building
Washington, D.C. 20510

Re: Record of the hearing on Technical Corrections (July 13, 1988)

Dear Senate Finance Committee:

As a New England regional Actuarial and Benefits Consulting firm with over 500 clients, we would like to register our comments on the implementation of the antidiscrimination testing outlined in IRS Code Section 89.

The tests will involve tremendous effort on the part of employers in collecting employee data, recording sworn statements, tracking eligibility rules and valuing benefit plans.

Preliminary reviews of a mid size client with a single work place and 4,500 employees shows as many as 20 separate plans to test under the existing definitions of Section 89. The expense of testing this number of plans will pressure employers to cut back benefit options to a standard minimum. Provision of more generous benefit packages available to all employees will be discouraged for fear that the higher paid will opt for this coverage, causing problems with discrimination testing.

Implementation of Section 89 is impossible without regulations covering the many specific applications where ambiguities now exist. To date the central element of testing, the method for valuation of health benefits, is not described in the law. Once regulations are issued we would require at least one year to review clients plans, recommend any changes and help them develop computer capabilities for the data collection required.

We urge you to consider simpler, less costly proposals for assuring that nontaxable employee benefits do not discriminate in favor of highly compensated employees. The expense employers will undertake in testing under the current law will be a large waste of resources better spent.

Sincerely,

Daniel M. Arnold

Daniel M. Arnold

/jcb

cc: APPWP

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July 13, 1988

HAND DELIVERED

Ms. Laura Wilcox
Hearing Administrator, U.S. Senate
Committee on Finance
Room SD205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on S.2238, Technical Corrections Act of 1988, Effect of 1986 Tax Reform Act Retroactive Repeal of Investment Tax Credit on Horizon Air

Dear Ms. Wilcox:

This statement explains an unusual and totally unforeseen problem now facing Horizon Air Industries, Inc. d/b/a Horizon Air, a large commuter air carrier based in Seattle, Washington, as well as its parent corporation, Alaska Air Group, Inc. also headquartered in Seattle. The problem arises from the retroactive repeal of the investment tax credit which under the legislative history of the 1986 Tax Reform Act was not supposed to adversely affect contracts entered into prior to January 1, 1986. However, because of the unusual confluence of circumstances set forth below, Horizon will be deprived of any investment tax credit unless a technical correction addressing Horizon Air's problem is included in S.2238.

The relevant facts are next discussed.

On August 30, 1985, Horizon Air Industries ("Horizon") entered into a contract for the purchase of ten new DHC-8 aircraft from The De Havilland Aircraft of Canada Limited ("De Havilland") at a cost of $5.55 million each (total purchase price of $55.5 million). Horizon made a downpayment of $1 million on the contract. Expected delivery dated were December 1985 through November 1986. Horizon agreed to assign the purchase contracts to UT Financial Services Corporation ("UT Financial") in December 1985 and to lease the planes back from UT Financial. The leases contemplated that UT Financial would be entitled to an investment tax credit of 10 percent of the cost of each plane and provided that, if such credits were not available, Horizon would pay an increased monthly rent to UT Financial over the 14 year lease term.

The Tax Reform Act of 1986 retroactively repealed the investment tax credit for property placed in service after 1985 unless certain transitional rules applied. Horizon satisfied one of the statutory transitional rules since it had a binding contract to purchase the aircraft prior to December 31, 1985. However, the Conference Report states that the "binding contract" exception is not available if a contract has a liquidated damages clause providing for damages of under 5 percent of the contract. Since the Horizon-De Havilland contract limited damages to the $1 million downpayment (roughly 2 percent of the contract price), it would not be considered "binding" under that report, despite the fact that $1 million is by no means a minimal amount of damages.

The obvious policy behind the Conference Report is to require that payments under a liquidated damages clause in a purchase contract be significant enough such that the buyer will not easily "walk away" from the contract. Only under such circumstances can a contract truly be considered binding. In implementing this policy, the Conference Report assumed that a 5 percent damages clause would ensure that a buyer would not default on a contract. However, in the context of a company such as Horizon, those same policy considerations are satisfied in the instant case. Clearly Horizon was not going to walk away and leave $1 million on the table. Horizon's average operating revenues for its 1984 and 1985 fiscal years were only $51 million and it had an average net operating profit of only $1.15 million for those same years. The $1 million downpayment was extremely significant to Horizon and ensured it would honor this contract, as in fact, it did. Obviously, this contract was binding on Horizon when it was signed in 1985 in every real sense of the word.

Nine of the ten planes were in fact placed in service during 1986 (one each in February, March, June, September and November and four in December) and Horizon is paying additional monthly rents of approximately $58,900 because of the unavailability of the investment credit. Over the fourteen-year lease term, Horizon will be required to pay approximately $9.9 million in additional rents, which costs must be passed on to air travel customers in the Northwest United States. To the extent the costs cannot be passed on to customers, Horizon will have to reduce its employee or other costs to remain competitive, thus setting off significant repercussions among Horizon's almost 1000 employees in the states of Washington, Oregon, Idaho, Montana and Utah.

In April 1987, UT Financial exercised its contractual right to lock-in the higher monthly lease payments predicated on the assumption that the investment tax credit would not be available. However, UT Financial also transferred to Horizon the right to pursue the investment tax credit to which Horizon believes it should be entitled. If Horizon Air can realize the investment tax credit on these 10 aircraft which it most certainly deserves and thereby partially offset the now permanent higher lease payments Horizon is required to pay UT Financial, that savings can be passed on to its customers in the form of fare reductions as well as helping Horizon's employees and the many business which rely on Horizon.

Sincerely yours,

Marshall S. Sinick

MSS:nlh
Enclosure

cc: Honorable Charles A. Vanik
William Diefenderfer, Esq.

WRITTEN STATEMENT SUBMITTED TO THE SENATE FINANCE COMMITTEE CONCERNING JULY 13, 1988, SENATE FINANCE COMMITTEE HEARING ON THE TECHNICAL CORRECTIONS ACT OF 1988 BY QUINCY S. ABBOT, SENIOR VICE PRESIDENT, THE CIGNA CORPORATION ON BEHALF OF THE INSURANCE ACCOUNTING GROUP CONCERNING THE INSURANCE ACCOUNTING PROPOSAL INTENDED TO ELIMINATE ON A REVENUE NEUTRAL BASIS THE NEGATIVE IMPACT ON FINANCIAL REPORTING OF THE LOSS RESERVE DISCOUNTING REQUIREMENT FOR INSURANCE COMPANIES OF THE TAX REFORM ACT OF 1986

The Insurance Accounting Group ("IAG") consists of a group of companies engaged in the property and casualty insurance business. Companies included in the group include the following: The Travelers Insurance Company, Cigna Corporation, CNA Insurance Companies, The Hartford Insurance Group, USF&G, Lincoln National Corporation, North American Company, St. Paul Fire and Marine, Chubb & Son Insurance, Firemans Fund, Continental Insurance Company. The Chairman of the IAG is Quincy S. Abbot, Senior Vice President, of Cigna Corporation. The IAG requests that the Senate Finance Committee include as part of the tax legislation it is preparing the **Insurance Accounting Proposal**. The **Insurance Acounting Proposal** is intended to eliminate on a revenue neutral basis the negative impacts on financial reporting of the loss reserve discounting requirement enacted as part of the Tax Reform Act of 1986.

The purpose of this proposal is not to urge the Congress to revisit its basic decision concerning discounting but to eliminate the negative impacts on both regulatory surplus (net worth) and shareholder reporting through a technical Internal Revenue Code amendment which is specifically designed to have no revenue cost.

The proposal would have the effect of permitting insurance companies to establish an asset which would reflect the ability to deduct the discount component of the reserve at some point in the future. This result would be accomplished on a revenue neutral basis. The proposal accomplishes these results by providing insurance companies with a separate temporary deduction with respect to the difference between the amount of reserves which the taxpayer has on an undiscounted basis and the amount of the reserves which the taxpayer has on a discounted basis (hereinafter referred to as the "Discount Deduction"). The amount of the Discount Deduction flows into a special reserve account. The amount generally flows back into income in the year in which the taxpayer would have been otherwise entitled to the Discount Deduction. The Discount Deduction may be taken only if the taxpayer also prepays through a separate estimated tax payment the tax which will be generated when the amount in the special reserve account flows back into income.

A taxpayer is entitled to utilize the separate estimated tax payment only against taxes due and only when the amount in the special reserve account is brought back into income. This will occur generally in the year in which the taxpayer would have otherwise been entitled to the Discount Deduction (i.e., when it would have been otherwise deductible as an addition to the regular loss reserve account). In the unlikely event that the taxpayer has incurred no tax liability as a result of the release of the special reserve back into income at the end of 15-years, the taxpayer is entitled to a separate refundable tax credit equal to the unutilized separate estimated tax payment at that point. Given the normal business cycle of the insurance industry and the increased level of income tax generally under the 1986 Act, this as a practical matter is an extremely remote possibility.

Following this summary is a detailed description of the proposal. Any questions with respect to the proposal should be directed to the tax counsel for the IAG as follows:

Kenneth J. Kies, Esq.
Baker & Hostetler
1050 Connecticut Avenue, N.W.
11th Floor
Washington, D.C. 20036
202-861-1566

DETAILED DESCRIPTION OF PROPOSAL TO ELIMINATE ON A REVENUE NEUTRAL BASIS THE NEGATIVE IMPACT ON FINANCIAL REPORTING OF THE LOSS RESERVE DISCOUNTING REQUIREMENT FOR INSURANCE COMPANIES OF THE TAX REFORM ACT OF 1986

I. INTRODUCTION.

A. Changes in Tax Reform Act of 1986 Act Affecting Insurance Companies Engaged in the Property/Casualty Insurance Business.

As a result of the enactment of the Tax Reform Act of 1986, insurance companies engaged in the property/casualty insurance business are now required to discount loss reserves and to accelerate the taxation of the unearned premium reserve. Such companies also are required to reduce the deduction for incurred losses in an amount equal to 15% of tax-exempt interest and the dividends received deductions attributable to investments acquired after August 7, 1986.

The discounting adjustment and the unearned premium adjustment accelerate the recognition of taxable income. Insurance companies will report in financial statements the same amount of earned premium and deduct the same amount of losses but the accounting periods when the income and deductions will be taken for tax reporting now differ from those applicable for financial reporting. In the vernacular of the accounting profession, these differences are described as temporary differences.

In addition, all companies, including insurance companies, are subject to a new corporate alternative minimum tax. The new corporate alternative minimum tax in most cases assures that a corporation will pay tax because tax loss carryovers and tax credit utilization is limited to 90% of the tentative minimum taxable income before tax loss carryovers and tax credits. Further, in computing corporate alternative minimum taxable income, companies generally must include fifty percent of unreported business profits in corporate alternative minimum taxable income.

B. Negative Effects of Discounting on Reporting by Insurance Companies to State Regulators and Shareholders.

This proposal is generally intended to address, on a revenue neutral basis, the significant negative impact on insurance companies reports to state regulators and shareholders which results from the discounting requirement. This negative effect limits the ability of companies to write insurance due to the reduction in the surplus of the companies. For example, consider a company that earns $300 in premiums and establishes on its books $300 in undiscounted loss reserves with the related discounted loss reserves equal to $200. It must pay and accrue against regulatory surplus $34 of tax with zero pre-tax income because state regulators will not permit establishing a $34 tax asset in anticipation of deducting the $100 of discount as it accrues to the reserve for tax purposes. The $34 tax paid reduces surplus (net worth). Since state regulators effectively limit a company's premiums written to three times surplus, the company's ability to underwrite new insurance is reduced by roughly the amount of the discount. Likewise, FAS No. 96[1], which governs financial reporting to shareholders, generally limits the company's ability to reflect the entire $34 tax asset, thus, resulting in a reduction of reported earnings.

C. Initial Analysis of the Revenue Effects of The Tax Reform Act of 1986.

An initial analysis of the impact of the 1986 Act on insurance companies in the property/casualty business suggests that the revenue effect of the 1986 Act is significantly exceeding what was projected at the time the legislation was enacted. Discussions with individual companies support this conclusion. More significantly, however, the Insurance Service Office, Inc. ("ISO")[2] has prepared and recently released an overall study of this effect entitled "The Effects of the 1986 Tax Reform Act on the Property/Casualty Insurance Industry," (March 1988). The general conclusions of the report contained in its Executive Summary are as follows:

> The property/casualty industry's 1987 federal income tax bill is estimated to be $2.8 billion, or $2.4 billion more than would have been paid under the old law. The $6.6 billion tax increase in 1988 and 1989 calculated in the study, combined with the additional $2.4 billion for 1987 because of the new law, means that the industry will pay $9.0 billion more over that three-year period than under the old law. (See Appendix II.) This tax burden surpasses the federal government's preliminary projection of an additional tax liability for the property/casualty insurance industry of $7.5 billion over the five-year period from 1987-1991.[3]

Much of the increased revenue effect is due to the discounting provision. As a consequence, the negative effects upon financial reporting to shareholders and state regulatory authorities is significantly greater than would be the case if the 1986 Act was causing only the revenue effect which was anticipated at the time of its enactment.

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[1] FAS No. 96 is a recent statement of the Financial Accounting Standards Board which governs accounting for income taxes. It was promulgated in final form in December 1987.

[2] ISO is a non-profit corporation that makes available advisory ratings, statistical, actuarial, policy form and related services to any U.S. property/casualty insurer.

[3] As reflected in the "Sensitivity Analysis" of the ISO study, its conclusions relative to the impact of the 1986 Act "remain virtually unchanged" as a result of variations in the key assumptions used in the study. See page 21 of the ISO study.

II. TECHNICAL EXPLANATION OF PROPOSAL.

A. Conceptual Description.

As indicated, the 1986 Act requires insurance companies to discount unpaid loss reserves under section 846 of the Internal Revenue Code of 1986, as amended,[4] whether or not the unpaid loss reserves were discounted in statements furnished to state insurance regulators or to shareholders. Insurance companies generally do not discount unpaid loss reserves in these statements except in some instances, such as workers' compensation income payments where the amount of the periodic payment is known.

Under this proposal, deductions for additions to a special loss discount account (hereinafter referred to as the "Discount Deduction") will be allowed but not in excess of the amount of discount attributable to losses incurred after December 31, 1986. Hence, no special deduction is allowed for losses incurred prior to January 1, 1987, which discount is eligible for the fresh start provision. Any amount added to the special loss discount reserve must be restored to income no later than the close of 15 years, which coincides with the loss carryforward period.

The Discount Deduction is allowed only if the company prepays, through a separate estimated tax payment, the tax which will be generated when the amount in the special reserve account flows back into income. The amount of the separate estimated tax payment will equal the amount of the tax benefit of the deduction. Like other estimated tax payments, these separate estimated tax payments will be treated for financial accounting purposes and regulatory accounting purposes as an asset. These separate estimated tax payments may be credited against the taxpayer's tax liability only as the amount in the special reserve account flows back into income. This will occur generally in the year the deduction would otherwise have been utilized. If the company has no tax to pay by the end of year 15 because of other deductions, the company is entitled to a separate refundable tax credit equal to the amount of the unused separate estimated tax payments.

The proposal generally will apply for purposes of calculating potential corporate alternative minimum tax liability in the same manner it does for purposes of calculating the regular corporate tax liability. In determining whether a taxpayer has a corporate alternative minimum tax liability, the taxpayer would compare the corporate regular tax liability (including the amount of separate estimated tax payments made under this proposal) with the corporate alternative minimum tax liability (including the amount of separate estimated tax payments assuming the corporate alternative minimum tax applies). In computing the amount of separate estimated tax payments required to be made for corporate alternative minimum tax purposes it would be necessary to make the following assumptions: (1) the tax benefit would be computed by utilizing the 20% marginal rate; and (2) during those years (1987-89) that the book income adjustment applies, the impact of that adjustment would have to be taken into account in computing the tax benefit of the special Discount Deduction.

The proposal is designed to have no net revenue effect in any year. The tax effect of the additional Discount Deductions will be exactly offset by the required separate estimated tax payments in the exact amount of the tax benefits. As is the case for estimated tax payments generally, the separate estimated tax payments are treated as tax payments for all Internal Revenue Code purposes. The separate estimated tax payments may be credited against the taxpayer's tax liability generally in the year the deduction would otherwise have been utilized. There is theoretically a potential revenue cost at the end of 15 years when the refundable tax credit is triggered if no tax has been paid by reason of losses. The refundable tax credit feature of the proposal is vital to achieve the desired financial accounting and statutory reporting. Given that a 15-year period encompasses one to three property and casualty industry operating cycles, that enhanced taxable income is created by the 1986 Act, and that tax strategies will reflect the new corporate alternative minimum tax, it is highly unlikely as a practical matter that a company would not have paid a tax and utilized the separate estimated tax payments before the end of the 15-year period.

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[4] "Section" references are to provisions of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

While the proposal is applicable to taxable years beginning after December 31, 1987, the amendment provides special rules for Discount Deductions attributable to losses incurred after December 31, 1986, the effective date of section 846 added by the 1986 Act.

B. Example of Operation of the Insurance Accounting Proposal.

The application of the new section 832(g) may be illustrated by the example below. It should be emphasized that this example only illustrates the operation of the proposal for reserves initially established in 1990 and tracks the operation of the proposal for those 1990 reserves for tax years 1990, 1991, and 1992.

> Company A is required by state law or regulation to set aside undiscounted, unpaid loss reserves with respect to certain liability insurance. For 1990, the amounts so set aside with respect to losses incurred in 1990 is $300x. The related discounted, unpaid losses are $200x. Company A's taxable income, computed without regard to the Discount Deduction allowed by new section 832(g)(1), was $250x in 1990. By making separate estimated tax payments of $34x as required by section 832(g)(2), Company A was allowed a Discount Deduction of $100x for 1990. Company A added $100x to its loss discount account in 1990.
>
> At the end of 1991, Company A had undiscounted, unpaid losses incurred in 1990 in the amount of $200x and related discounted losses of $175x. Company A is required to subtract $75x from the special loss reserve discount account since the amount in the account with respect to losses incurred in 1990 may not exceed $25x (the excess of $200x over $175x). The $75x subtracted from the account must be included in gross income of Company A for 1991. Company A had taxable income of $100x for 1991 before inclusion of the $75x subtracted from the special loss reserve discount account in income. Since Company A will pay tax as a result of the amount released from the special loss reserve discount account in income, $25.5x of the separate estimated tax payments made in 1990 may be credited against the taxpayer's tax liability in 1991.

> At the end of 1992, Company A has taxable income of $500x before inclusion of any amount released back into income from the special loss reserve discount account. The amount of its undiscounted, unpaid loss incurred in 1990 is $150x and the related discounted, unpaid loss is $140x; i.e., the excess at the end of 1992 is $10x. Another $15x must be subtracted from the special loss reserve discount account and included in gross income. Since Company A pays additional tax in 1992 as a result of the inclusion in income of the $15x subtracted from the special loss reserve discount account, separate estimated tax payments made in 1990 with respect to the $15x of discount subtracted from the special loss reserve discount account in 1992 may be credited against the taxpayer's tax liability in 1992.

The overall results of this example are illustrated in chart form as Appendix A.

APPENDIX A

EXAMPLE OF THE OPERATION OF THE PROPOSAL FOR LOSS RESERVES INITIALLY ESTABLISHED IN 1990 FOR TAX YEARS 1990, 1991, AND 1992[1]

I. FACTS

YEAR	1990	1991	1992
Undiscounted Loss Reserves for 1990	$300X	$200X	$150X
Discounted Loss Reserves for 1990	$200X	$175X	$140X
Taxable Income Before Special Loss Reserve Deduction the Insurance Accounting Proposal	$250X	$100X	$500X

II. CALCULATION OF TAX LIABILITY

YEAR	1990	1991	1992
Taxable Income Before Discount Deduction	$250X	$100X	$500X
Special Reserve Deduction	($100X)	0	0
Addition to Gross Income as a Result of Release of Reserve in Special Loss Reserve Deduction Account	0	$75X	$15X
Taxable Income After Discount Deduction or Addition to Income Under Insurance Accounting Proposal	$150X	$175X	$515X

III. REQUIRED SEPARATE ESTIMATED TAX PAYMENTS AND STATUS OF SPECIAL LOSS RESERVE DISCOUNT ACCOUNT

YEAR	1990	1991	1992
Separate Estimated Tax Payments Required to be Made Under Insurance Accounting Proposal	$34X	0	0
Separate Estimated Tax Payments Credited	0	$25.5X	$5.1X
Separate Estimated Tax Payments Uncredited at End of Year	$34X	$8.5X	$3.4X
Special Loss Reserve Deduction Account	$100X	$25X	$10X

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[1] This example only illustrates the operation of the proposal for reserves initially established in 1990. The operation of the proposal for those 1990 reserves is shown for 1990, 1991, and 1992. Separate effects would occur for reserves initially established in 1991 and 1992.

Statement Submitted
by the
International Association of Drilling Contractors
and the
International Association of Geophysical Contractors

This statement is submitted by the International Association of Drilling Contractors (IADC) and the International Association of Geophysical Contractors (IAGC). These two associations represent, respectively, virtually the entire U.S.-based drilling and seismic industries.

IADC and IAGC urge the Senate Finance Committee to incorporate in the Technical Corrections Act of 1988 a change to permit meals provided by employers to personnel at all remote locations to be fully deductible.

IADC and IAGC were represented as part of an industry coalition by a witness before the Senate Finance Subcommittee on Taxation and Debt Management on July 22, 1987, and a written statement was also submitted in support of such a provision on that occasion.

The House Ways and Means Committee Print Summary of H.R. 4333 (WMCP 100-37) of July 15, 1988 (page 11) provides:

> 4. Full Deductibility of Business Meals Provided to Employees on Certain Vessels and Oil Rigs
>
> The Committee agreed that the 20-percent reduction rule normally applicable to business meals would not apply to an otherwise allowable deduction for expenses of food or beverages that are provided on an oil or gas platform or drilling rig if such platform or rig is located either offshore or in Alaska. The provision would apply for taxable years beginning after December 31, 1987.

> The Committee further agreed that the 20-percent reduction rule would not apply to expenses of food or beverages which are required by Federal law to be provided to crew members of a sea-going commercial vessel (including vessels operating on the inland waterways, but not applying to luxury water transportation).

While the IADC and IAGC are gratified that the House approach would restore full deductibility for their members engaged in offshore operations, the associations feel very strongly that onshore drilling and seismic operations should also be covered by this provision. Onshore and offshore drilling and seismic work sites at remote locations are identical, in that the employer must provide meals to employees where no alternative exists for those employees to procure their own meals. Thus, IADC and IAGC strongly urge that, in addition to the exemption provided in H.R. 4333 from the 80% limitation on deduction for such meals, language should be added to the provision to permit said exemption where food or beverages are also

> "provided in a remote location where satisfactory meals are not available on the open market, but only if such food and beverages are furnished in a common area which is located, as nearly as practicable, in the vicinity of the place at which such individual renders services, and not available to the general public."

The revenue impact of this further language would be *de minimis*. Moreover, it would be equitable, since the exigencies of providing food or beverages at remote onshore locations are similar to those for offshore locations, or in Alaska.

JPMorgan

Morgan Guaranty
Trust Company of
New York

23 Wall Street
New York NY 10015

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

We strongly urge the Senate Finance Committee to implement changes to the IRC Section 89 non-discrimination rules that will provide simplification and clarity without hindering the spirit of the legislation. As currently proposed, compliance under Section 89 non-discrimination rules will be an arduous and expensive task. Therefore, we request that you consider the following recommendations for rule simplification and a safe harbor.

Rule Simplification

- Annual Testing - Testing would occur annually. While the employer must still gather the necessary data to perform the testing, the tremendous resources for obtaining this data on a daily or monthly basis would be significantly diminished. Given our daily, monthly and annual processing requirements and the availability of computer-processing resources, it would be difficult to provide daily or monthly testing. In addition, the cost of implementing and providing programs which would analyze the daily or monthly data would far exceed the $125,000.00 which has been forecast for programming annual testing of health benefit programs. Annual testing would, we believe, sufficiently establish that the employer has complied with the IRC Section 89 Welfare Benefit Non-Discrimination Rules for employee plan membership and eligibility.

- Part-time Employees - Part-time status would be determined by the average number of hours worked over the previous six months. Our part-time hourly employees generally work less than twenty hours per week or less than eighty hours per month but may not follow a regular schedule. Because of this, averaging the number of hours over a six month period simplifies the task of determining an employee's status each week or even each month.

- Highly Compensated Employees - The group of highly compensated employees would be determined at the end of the calendar year based on W-2 wages. The top one hundred employees would be monitored monthly. Because annual bonuses are paid to many of our employees, it is difficult to determine who is highly-compensated at mid-year.

- Valuation - We support an interim valuation method that would allow the employer to establish a reasonable method for valuing plans.

- U.S. Citizens Abroad - Tracking the coverage of U.S. citizens hired by foreign offices is beyond our means. Valuing the coverage of these employees would be difficult, and control of the level of coverage is restricted by local law and practice.
- Plan Comparability - The range of comparability would be extended to twenty percent from five percent in order for plans to be aggregated for purposes of testing.
- Former Employees - Employees who separated from service before January 1, 1987 would not be included in testing. Compensation data would have to be retrieved and analyzed at great expense if this simplification is not implemented. Also, this data is not available in many cases prior to this period.
- Eighty-Percent Test - Employees and their dependents who have coverage elsewhere and for whom sworn statements have been obtained could be excluded from the eighty-percent test as well as the seventy-five-percent test.

Safe Harbor

A safe harbor which would require that an indemnity plan satisfy the following requirements would simplify compliance and yet ensure non-discrimination:

- Eighty percent of all relevant employees are eligible.
- Non-highly compensated employees would be required to contribute no more than 10 percent of compensation for single coverage and no more than 15 percent of compensation for family coverage.
- Highly compensated employees could be charged higher percentages.
- The employer would provide at least 60 percent of the plan cost.
- The employer would contribute uniform percentages across all plans as it pertains to non-highly compensated employees, including Health Maintenance Organizations (HMO's).
- The employee would be given the opportunity annually to leave an HMO and elect an indemnity plan.

These changes will go a long way toward reducing the negative health policy implications of the results of testing which would be to reduce options and experimentation. We believe that these changes would substantially increase the viability of testing and yet maintain the standards for which the non-discrimination testing was first proposed. We appreciate your consideration of our proposed changes to Section 89 regulations.

Respectfully,

Duane Abbott

key tronic®
The Responsive Input Company™

July 21, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if no most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as they may be required under state and federal law. It is fair to penalize employers who wish to provide employees with a choice among of gathering and maintaining data, as well as actual testing, are staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

- o Repealing Section 89;
- o Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- o Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Vern Osterback
Vice President Administration

WRITTEN STATEMENT
TO THE SENATE FINANCE COMMITTEE
ON PROPOSED MODIFICATIONS TO SECTION 2036(c)
TO BE CONTAINED IN S. 2238

INTRODUCTION

This statement is being submitted in response to Chairman Bentsen's announcement that hearings would be held on July 13, 1988 on proposed amendments to the Technical Corrections Bill to the 1986 and 1987 Tax Acts. Although our request to appear at those hearings was denied due to time constraints, we were encouraged to submit a written statement by July 25, 1988. Our statement is limited to subsection (c) of Section 2036 of the Internal Revenue Code, added by the Revenue Act of 1987 and titled "Inclusion Related to Valuation Freezes". This subsection presents major problems for all individuals potentially subject to estate and gift taxes and is especially threatening for farmers, ranchers and other business owners.

Each of the undersigned holds officer and committee positions in the Real Property, Probate and Trust Law Section of the American Bar Association. However, the statement that follows has not received the approval of the Council of the Real Property, Probate and Trust Law Section nor, of course, of the American Bar Association itself. Therefore the submission should not be taken as a submission of the American Bar Association or the Real Property, Probate and Trust Law Section, but rather the submission of the individuals listed below, in their personal and individual capacities.

Many of the undersigned have previously submitted to your staffs more detailed comments on the technical questions concerning Section 2036(c). A copy of some of those comments is appended to this statement. This statement will, however, focus on the most fundamental continuing problems with this subsection, particularly taking into account amendments to the Technical Corrections Bill proposed by Representative Rostenkowski, and will suggest an alternative approach.

BACKGROUND

Section 2036(c) as presently written has its origins in one of the two estate and gift tax "valuation" provisions included in the House version of the Revenue Act of 1987. The Senate version contained neither provision. In conference, one of the provisions was dropped. The other became Section 2036(c). Unlike the provision that was dropped, Section 2036(c) is only a valuation provision in the sense that it seems to be a substitute for a proper determination of the true value of property transferred in estate freeze transactions. We believe that the Service is fully capable of determining such value if they have adequate notice of the transaction. We also believe that even if Congress has a lack of confidence in the ability of the Internal Revenue Service or the Courts to make the necessary determinations of value, this does not justify a provision as sweeping as Section 2036(c) -- especially as there have never been hearings on this new provision.

The statutory language of Section 2036(c) is vague, overbroad and ambiguous. Virtually every word or phrase requires further definition. Very few such definitions are contained in the statute itself, a few more are found in the Committee reports. However, without exception, those definitions that are found in the statute and the Committee reports contain at least as many ambiguities as they resolve.

The Technical Corrections Bill introduced by Representative Rostenkowski (H.R. 4333) and Senator Bentsen (S. 2238) on March 31, 1988 (the "March 31 Bill") does not resolve any of these ambiguities. The proposed amendment to the Technical Corrections Bill (introduced to the House Ways and Means Committee by Representative Rostenkowski on June 21, 1988 has not yet been made public. However, as explained in the Description (JCX-11-88) prepared by the Joint Committee on Taxation staff and issued on June 21, 1988 (the "June 21 Proposal"), the proposed amendment addresses only a few of the numerous ambiguities and itself contains numerous additional ambiguities. The June 21 Proposal also would expand the reach of Section 2036(c) well beyond any application to which it could reasonably be said to have been initially intended and would delegate some of the fundamental aspects of the statutory provision to regulations. In addition, the June 21 Proposal would add certain "safe harbors" concerning the applicability of the statute that are so narrow that they, in practical effect, greatly broaden the reach of the statute.

As the discussion that follows will show, Section 2036(c) was ill conceived and is generally unworkable. It is incapable of being understood and enforced, either by practicing attorneys or the Internal Revenue Service. Its very existence, however, has penalized legitimate intrafamily gifts and sales of property. Section 2036(c) should be repealed and replaced with a different type of provision narrowly aimed at the valuation problems inherent in transfers of certain types of assets. The balance of these comments will illustrate more specifically some of the problems with the proposed amendments to Section 2036(c) and suggest an alternative approach.

SPECIFIC COMMENTS

Section 2036(c) subjects property no longer owned by a decedent to tax at the decedent's death if two statutory tests are met. The first of these, a "threshold test," requires that, in order to be subject to its operation, a person must hold 10% or more of the "voting power" or "income stream", or both, in an "enterprise." There are three ambiguities central to the application of this test: what is an enterprise? what is meant by the words "voting power" and "income stream"? and when is this test applied? Of these three ambiguities only one is clarified by either the March 31 Bill or the June 21 Proposal. That one, the determination of when the test is applied, is answered only by the June 21 Proposal and the answer is overly broad.

Under the June 21 Proposal this test would be met if it is met either before a transfer of an interest in an enterprise or after a transfer of an interest in an enterprise. Such a rule would, depending on the definition of an enterprise, totally emasculate the threshold test. It would be a rare situation where immediately **after** a transfer, the transferor either directly or through the attribution rule wouldn't own a 10% interest in the property transferred. Thus, contrary to the plain wording of the statute as presently written, the proposal would appear to apply this statute to the creation of a new enterprise with cash, and perhaps even to cash gifts to trusts, again depending on the definition of an enter-prise. This could produce absurd results, which would be unforeseen by most taxpayers. It discourages joint investment by members of the same family (with no discernible public policy reason for doing so) and potentially subjects property that a decedent never owned to tax at the decedent's death.

It should be noted, that the Conference Committee Report to Section 2036(c) states than an enterprise includes "a business or other property which may produce income or gain." However, since even cash may produce gain (as the world's currency markets fluctuate), this definition is so broad as to be meaningless.

The second test for taxation under Section 2036(c) is that the individual who holds this 10% interest in the enterprise transfer (after December 17, 1987) a disproportionately large share of the potential appreciation in the enterprise while retaining a disproportionately large share of the income or other rights in the enterprise. This disproportionality test has even more significant ambiguities.

It too, of course, requires a definition of the word, "enterprise." It also fails to state how disproportionality is to be determined.

To what is the potential appreciation transferred to be compared? To what is the retained income or other rights to be compared? And when is the comparison to be made? The June 21 Proposal appears to answer the comparison question, although the description of the Proposal is too cryptic to decipher the solution and scrutinize its merits. It appears that the Code Section would be rewritten to provide that Section 2036(c) would apply if an individual transfers a disproportionately large share of the potential appreciation in an enterprise as compared to the proportionate share of income or other rights in the enterprise retained by the transferor. If so, such a change would expand Section 2036(c) beyond "valuation freezes" to include previously transferred non-voting stock in the estate of a transferor who owns voting stock in the same corporation. (The right to vote is considered an "other right" in the enterprise.) This result is seemingly inconsistent with Section 2036(b), which was passed by Congress years ago to deal with transfer tax issues raised by the retention of voting rights. Under that subsection, the transfer of non-voting stock while retaining voting stock does not cause the transferred non-voting stock to be subject to estate tax. It seems inappropriate to leave section 2036(b) unchanged while addressing the issue of voting rights in a broader but considerably less direct way.

Of course, another fundamental question relating to the disproportionality test involves what constitutes a share of the "income of an enterprise." Common sense indicates that only a dividend or "profit-type" interest should constitute a share of income of an enterprise. The June 21 Proposal, however, in providing certain "safe harbors," indicating what does not constitute a share of income of an enterprise, expands, by negative implication, the ordinary meaning of this phrase, and, the application of the statute, in an extraordinary fashion.

For example, does the owner of a building that is rented to a corporation at a fair market value rental have an interest in the income of the corporation? Similarly, does a creditor of a corporation, or an employee of the corporation, have an interest in the income of the corporation by virtue of his right to interest or salary payments? By making very specific and strict safe harbors, the June 21 Proposal would suggest that the general answer to each of those questions is "yes".* For example, the June 21 proposal states that

> "an amount would not be includable in a person's estate solely because that person received or retained certain debt lacking equity features. Such debt would have to meet specified requirements regarding term, interest rates, payment dates, voting rights and conversion."

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* In addition, buy-sell agreements entered into with formulas other than "fair market value" which are acceptable under current regulations (and which avoid litigation and/or arbitration expenses associated with a "fair market value" formula) would be subject to IRC §2036(c).

Consider the first stated requirement, that of "term". Assume that an individual sells his entire interest in a corporation to his son and takes back an installment note with a 30-year term. If the safe harbor requires a term of no more than 25 years, the right of that individual to interest on that installment note would be considered a retained interest in the enterprise possibly subjecting to tax on the individual's death the value of the corporation **at the individual's death**, which might occur twenty or thirty years in the future. Such inclusion could potentially wipe out the individual's estate. This would be true under the proposed effective date rule even if that note was entered into on December 18, 1987 before this safe harbor was even considered.

This example points out another problem with Section 2036(c) as written -- its applicability to sales between family members. As drafted, even full fair market value sales to family members are caught within the reach of this statute. That issue, and the unfairness and possible unconstitutionality of it, is not a new issue and has been discussed at length in our prior comments to this statute. These comments will not be reiterated except to point out that the application of this rule illustrates another fundamental ambiguity in the existing statute. The existing statute says that when consideration is paid in the course of the transfer described in Section 2036(c), there will be an offset with respect to the amount included in the estate for the value of the retained interest. This result makes no sense, is inconsistent with the Committee report which indicates that this offset will be for the consideration paid, and should have been clarified in the March 31 Bill or in the June 21 Proposal. That this key issue has yet to be clarified provides another example of how vast the problems with this statute are and why they simply are beyond repair at this time.

Another fundamental problem with the statute arises from a provision that says that an individual and the individual's spouse shall be treated as one person. The scope of this rule is totally unclear. It could be read to mean that if a husband owns preferred stock in a corporation and a wife owns common stock and the wife transfers the common stock to the child, then on the husband's death (if the preferred stock passes to or for the benefit of the wife) the common stock previously transferred by the wife will be included in the husband's estate with no offsetting marital deduction, and will also be subject to tax again on the wife's death. This does not make sense. The June 21 Proposal does not offer to correct this problem, but merely grants regulatory authority (which may not issue for years) to narrow the application of this provision in some unspecified manner.

Yet another basic problem with the statute is that it is not clear how the Internal Revenue Service will collect the tax the statute purports to impose, particularly where the estate is not sufficient in relation to the value of the corporation owned by someone else. This becomes particularly true in the case of a family member who paid full fair market value for the property. The June 21 Proposal purports to deal with this specific aspect of the problem, but the proposed solution is unclear. Consider this example. Parent sells common stock to one of three children while retaining preferred stock. Child pays full fair market value, which is $1 million at the time of the sale. When parent dies, the common stock is worth $5 million. The proposal implies that the $2.5 million or so of tax that is owed on the common stock owned by the child at the death of the parent would be collectible against the child, a bona fide purchaser who paid full fair market value for the stock. Is this fair? Is it constitutional? Regardless, it certainly encourages the parent to sell the stock to a stranger and discourages the child (or any other family member) from buying the stock.

The final aspect of Section 2036(c) that will be addressed in these comments is a change contained in the March 31 Bill and a modification of that change in the June 21 Proposal. As Section 2036(c) is presently written, a transfer of a retained interest within three years of death would bring the subject property back into the transferor's estate. However, a transferor who transfers that property more than three years before death would not be subject to tax. This is consistent with Section 2036(a). For example, if a taxpayer creates a trust and retains the right to receive trust income for life and then, within three years of death, transfers the retained interest to another, the full value of the trust will be included in the taxpayer's estate and subject to tax at his death. However, if the taxpayer transfers the retained income interest more than three years before death, the trust will not be subject to tax at his death. This is appropriate because he has paid gift tax on the full amount of the property transferred, the remainder interest at the time of the original transfer and the income interest at the time of the subsequent transfer. Section 2036(c) would say, however, if it is modified as proposed, that the subsequent transfer would trigger an additional gift tax of the underlying property, the value of which would be reduced only by the value taxed on the earlier transfer. For example, if a taxpayer gives away common stock, retaining preferred stock and later gives away the preferred stock, he would be deemed to have made a second gift of the common stock at the time of the gift of the preferred, reduced only by the value of common taxed on the first gift. Similarly if parent and child each own common stock in a corporation and the corporation redeems parent's stock for a note, not meeting the safe harbor, there would be a taxable gift to the child of the portion of the company previously owned by the parent, **when the corporation pays off the note**. If principal payments are made annually, this might even mean annual deemed gifts causing a revaluation of the company annually!

Why should this be the result? If Section 2036(c) is not intended to make Section 2036(a) unnecessary, why should there be a different result with stock in a corporation than with an income interest in a trust? If Section 2036(c) is intended to make Section 2036(a) unnecessary and apply to any transfer of property, then, **by technical correction**, a very fundamental change is being made to our system of gift and estate taxation. The same gift would be subject to gift tax at two different times and at two different values.

There is presently a debate as to whether our current system of transfer tax should be converted from one that makes it easy to complete gifts and pay tax early to a "hard to complete" system. The Treasury Department noted in its "Treasury I" proposal in 1984 that Section 2036(a) is a flawed concept of transfer taxation. The June 21 Proposal would exponentially compound these inherent flaws by modifying our current system to one where gifts are both easy to complete and hard to complete. Specifically, a gift tax event would occur both at the time of the initial transfer and then again at a subsequent date. Such a change would create a heads the government wins, tails the taxpayer loses situation.

PROPOSAL

Section 2036(c) should be repealed. No one has yet been able to propose a set of technical corrections that address the myriad of elementary questions, ambiguities and problems associated with this statute, let alone the numerous less elementary but no less significant problems that are not even touched on in this Statement. This indicates that Section 2036(c) cannot be fixed in a timely enough fashion to avoid serious disruption to family farms and businesses and others who simply wish to plan for an orderly disposition of their assets.

We recommend that, as a first step, the legislative process identify the true scope of the problem Section 2036(c)attempts to address. Is there an abuse when someone gives away common stock and pays a gift tax based on the fair value of that common stock, even if the preferred stock in a corporation is retained? Is there an abuse if a person sells common stock at its full fair market value, even if that sale is to a family member? If it can reasonably be demonstrated that these situations can present an abuse, can a statute be drafted to address the abusive situations only? If not, is the abuse so great as to warrant a statute that virtually forbids intra-family sales of businesses and farms and encourages sales outside of the family?

The undersigned believe that if there is a problem in valuation freezes it probably relates to transfers of business property where the taxpayer making the transfer has an advantage over the Internal Revenue Service by virtue of his special knowledge about his business. As our tax laws are presently written, such an individual can undervalue an initial gift and escape tax because of the expiration of a statute of limitations. In some cases this can even occur without the Internal Revenue Service ever being notified of the transfer. For obvious reasons this problem does not apply to transfers of cash, or marketable securities, or other property with respect to which inside knowledge is not a factor.

In lieu of Section 2036(c), consideration should be given to a detailed and specific notification requirement before the gift tax statute of limitations will run on a transfer of a growth interest in a business. The notification requirement should perhaps even require that the Service be told about post-transfer events that might provide insight into the true fair market value of the property at the time of transfer. This would be a less intrusive, considerably simpler and more direct approach to solving the problem that appears to have initially been attempted to be addressed by 2036(c).

The undersigned would be happy to assist in further developing this (or another) alternative proposal.

CONCLUSION

Even if Section 2036(c) is not expanded by a Technical Corrections Bill, it is a "solution" that is not commensurate with the "problem." It ignores the fact that many families have members with unequal abilities to run a business, or that a family business may not have room for all family members. Patriarchs and matriarchs of family businesses who no longer have the ability, or the inclination, to continue to run those businesses could formerly treat all family members fairly, by organizing the business to permit the "working" family members to earn a salary and equity incentives to make the business grow, while the "non-working" family members receive a preferred income stream for their investment. Prohibiting businesses from organizing in that fashion, to solve gift tax valuation problems, is a draconian measure.

Respectfully submitted,

Anthony B. Kuklin
L. Henry Gissel, Jr.
John J. Lombard, Jr.
William B. Dunn
Joseph Kartiganer
John A. Wallace
Malcolm A. Moore
Stephen A. Cowan
Robert O. Hetlage
Lloyd Leva Plaine

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Pam H. Schneider
Jonathan G. Blattmachr
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July 20, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as they may be required to under state and federal law. Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, are staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated," but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

> Repealing Section 89;
> Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
> Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated

Sincerely,

Lael M. Maynard

Lael M. Maynard
Benefits Manager

LEACH CORPORATION
6900 Orangethorpe Avenue, Buena Park, California 90620 • Telephone (714) 739-0770 • TWX 910-596-2867

July 19, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen, Senate Office Building
Washington, DC 20510

Subject: Section 89 Comments for the Record of the Hearing on Technical Corrections

Dear Ms. Wilcox:

This letter is to ask relief from the onerous requirements of Section 89. We are a medium-sized company and have at least six plans that would be affected by this regulation.

As a medium-sized company, I rely on outside expertise to help in the interpretation and compliance with benefit laws and regulations. The best advice I have received at the present time indicates that, although we offer three HMO's which we chose in order to give employees individual options and choices between a total provider concept to group practice and individual practitioners under the HMO concept, under Section 89 none of the plans would be qualified, even though we offer them on the same basis to all employees with the same company contribution for all employees and dependents. Despite our own effort to be fair, reasonable and non-discriminatory with our employees, we are told that we would not be in compliance with the non-discrimination provisions of Section 89. If this is wrong, then the regulations are so complicated that so-called experts whom we call on for advice are unable to properly interpret them.

This points up a problem then for the average business person, who is already overburdened by government requirements from the federal, state and local levels, to know whether he/she is in compliance with the laws and regulations. If such laws and regulations are so complicated that practitioners in the field can not agree, then the regulations need to be made clearer, simpler, more understandable and easier to administer. If they are not, there will not be compliance; not because of a desire not to comply, but because of an inability to comply.

As a business person stuck with the job of trying to assure that my company complies with all requirements, I am imploring you to simplify the regulations; make them practical and reasonable with adequate flexibility for employers to meet the individual needs of their business and employees.

Sincerely,

LEACH CORPORATION

W.L. Babecky
Vice President
Industrial Relations

WLB:ps

COUNTY OF LOS ANGELES
CHIEF ADMINISTRATIVE OFFICE
713 HALL OF ADMINISTRATION / LOS ANGELES, CALIFORNIA 90012
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RICHARD B. DIXON
CHIEF ADMINISTRATIVE OFFICER

July 21, 1988

The Honorable Lloyd Bentsen
Chairman, U.S. Senate Committee on Finance
50-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

COMMENTS ON SECTION 89 IRC AND RELATED AMENDMENTS INCLUDED IN THE TECHNICAL CORRECTIONS ACT OF 1988

On behalf of the County of Los Angeles, I offer the enclosed written comments recommending repeal or amendment of Section 89 of the Internal Revenue Code. I request that you include these comments in the record of the July 13, 1988 hearings conducted by the Senate Committee on Finance regarding the Technical Corrections Act of 1988 (H4333 and S2238), and I urge your consideration and positive action on our recommendations.

We understand and agree with a national policy which ensures that employee benefits are made available to non-highly compensated employees in a non-discriminatory manner. Consistent with this national policy goal, the County, like virtually all other State and local government employers, makes available uniform benefits to its employees.

The complex and costly analysis, compliance and reporting requirements imposed by Section 89 fall particularly heavily on governmental employers in view of our current compliance with its spirit and intent. This added burden on 8.2 million County taxpayers is consequently very difficult to justify.

We at the County of Los Angeles therefore urge your consideration of either repeal, exemption of State and local government employers, or at a minimum, radical simplification of Section 89 as described in our enclosed written testimony.

If I or my staff can be of any assistance to you as your consideration of amendments to Section 89 continues, please do not hesitate to call on me.

Sincerely,

RICHARD B. DIXON
Chief Administrative Officer

RBD:DRD
BC:jg
9:vp

Enclosure

WRITTEN TESTIMONY ON SECTION 89 IRC AND RELATED AMENDMENTS INCLUDED IN THE TECHNICAL CORRECTIONS ACT OF 1988

PRESENTED TO THE SENATE COMMITTEE ON FINANCE BY LOS ANGELES COUNTY ON JULY 21, 1988

I am Richard B. Dixon, Chief Administrative Officer of Los Angeles County. I am pleased to present to the Senate Committee on Finance the County's view concerning amendments you are considering to Section 89 of the Internal Revenue Code.

The County agrees that ensuring that employee benefits are made available to rank and file employees in a non-discriminatory manner is a desirable national policy goal. Consistent with the intent of this national policy, the County, like virtually all other State and local government employers, makes a uniform package of benefits available to its employees.

The complex and costly analysis, compliance and reporting requirements imposed by Section 89 fall particularly heavily on revenue short governmental employers in view of our current compliance with its spirit and intent. With a workforce of over 82,000 full and part time employees, the front end investment to implement the testing and reporting requirements at $15 per head could exceed $1,230,000 in local tax dollars. Other potential costs could run millions more.

It would be politically unrealistic and practically impossible for the County and other public agencies to justify discriminatory benefits to our constituents. In view of the fact that we have and intend to continue to have an egalitarian welfare benefit program, the cost of the additional burden imposed by Section 89 on the County's 8.2 million taxpayers is very difficult to justify.

Moreover, there is general agreement among employers that the assumptions underlying Section 89's compliance strategy are fundamentally flawed. In addition, it seems to us that the proposed amendments, which appear intended to provide additional reasonable exceptions to the law's restrictions succeed only in making compliance more costly and complicated without achieving Congress' goal. An illustration of the employee relations, employment and legal environment in which the County operates, one not unlike that faced by other large governmental and private sector employers, shows why.

Section 89 is intended to prevent a perceived abuse in which an employer has two benefit options; a low option for rank and file employees and a high option for highly compensated managers and officers. The clear objective of the Section's requirements is to determine whether the value of these two benefit options differs enough in favor of the highly compensated to establish a likelihood of tax abuse. In order to afford reasonable leeway for employers whose plans differ slightly from this expectation, Section 89 provides alternate testing strategies: a simpler 80% coverage test and a more complex and costly to implement battery of tests including the 50% eligibility test, the 90%/50% eligibility test and the 75% comparative benefits test. In addition, Section 89 allows limited exclusions, primarily those for collectively bargained agreements, part-time employees and employees who have alternative coverage provided by another employer.

Los Angeles County's benefit program, like that of many other large employers, differs greatly from the unrealistic assumptions of Section 89. The differences and corresponding implications for compliance testing are:

1. Multiple Benefit Options. The County offers six health insurance plans, three dental plans, one group life insurance program with both subsidized and unsubsidized options, and an accidental death and dismemberment program with several options. When the current Section 89 plan definition is applied, these expand to at least 20 plans or plan options for testing purposes, a very costly testing task. A proposed cosmetic amendment to Section 89 would permit the County to combine plans for plan drafting purposes. But it would not reduce our testing responsibility and it would not change testing outcomes in any way.

2. Equal Access to County Benefits. The long standing County solution to the discrimination problem has been to make all benefits available to all employees on a reasonably comparable basis. Both non-highly compensated and highly compensated employees may choose from among these programs. Because employees have equal access to any one of many County provided benefit options no one plan covers 80% of our non-highly compensated rank-and-file employees. In fact our largest health plan enrollment is 39% of our employee population. Because these negotiated benefits differ significantly in value it is very unlikely that they can be aggregated to pass the 80% coverage test. It is conceivable but not very likely that they can pass the proposed test now being considered by your Committee which would broaden coverage but reduce required comparability of plan benefits. As a result, the County probably will be forced to consider the more complex and costly alternative battery of tests described above.

3. Plans Subject to Agreement With Unions. Each of our plans was negotiated with the County by our employee unions to serve the needs of the County's 55 separate collective bargaining units. There are significant differences in benefit and value among these programs which are tailored to the health care and life insurance preferences of the diverse employee groups that negotiated them with us. As a result, whether our benefits will pass tests designed to approach the issue of discrimination from a different set of assumptions than the County has relied on up to now is problematic.

4. Collective Bargaining Exclusion. Section 89's collective bargaining exclusion is not available if both represented and non-represented employees are eligible to participate. The County policy of making all benefits available to all employees thus prevents us from protecting our represented employees and thereby reducing our testing responsibility under the law.

   The County cannot unilaterally change its policy because public employee benefits are subject to collective bargaining under State governmental employee relations law. Neither would it be cost effective to restrict membership in our existing plans to represented employees. Adverse selection and market factors would surely drive up benefit costs for both represented and non-represented employees.

5. The Majority of Highly Compensated Employees Are Represented Rank-and-File. Of the over 7,000 County personnel who are highly compensated as defined by Section 89, only 37% are managers, professionals, administrative support specialists and elected County officials including judges. The vast majority, or 63% of

> the highly compensated, are represened rank-and-file employees, primarily health support professionals, police and firefighting employees whose compensation includes substantial overtime. Section 89's restrictively drafted collective bargaining exclusion prevents us from protecting these represented rank-and-file employees whom we think Congress never expected to be penalized.

In summary, we think it clear that Section 89 works in ways never intended by Congress. In addition, while the Technical Corrections Act's many proposed fine tuning amendments may provide relief in isolated cases, their primary effect will be to force employers, like the County who are already in compliance with either the specific requirements or the spirit and intent of the law, to cast about at considerable cost to prove, perhaps fruitlessly, that they are indeed in compliance. In the process, employees who should not be penalized may be hurt unfairly.

As an alternative we recommend that your Committee consider the following options:

1. Repeal of Section 89, and replacement of it with a straight forward strategy for achieving Congress' goal of expanding health coverage.

2. Exempt State and Local Governments from Section 89's Requirements. It is not realistic to assume that State and local taxpayers ever have or ever will tolerate wide disparity in pay or benefits among government employees.

3. Radically Simplify Section 89 to deal more realistically with taxation of employer benefit plans. Here are some suggestions:

    a. Modify the collective bargaining exclusion to provide that negotiated benefits may be excluded from testing if the majority of participants are party to a collectively bargained agreement covering these benefits. At a minimum, Congress should consider removing all represented employees who are party to a collectively bargained benefit agreement from the testing base on the theory that such employees do not need tax law protection.

    b. Reduce and simplify testing and data gathering requirements. Specifically, you should lower coverage requirements to recognize that it is mathematically unlikely for responsible employers to pass the tests if they offer multiple options to employees. We also urge that you adopt proposed amendments to Section 89 which would permit employers to test as of a specific day of the year instead of testing for the entire year and to collect sworn alternate coverage waivers every three years instead of annually.

    c. Provide that employers may use employer cost as a permanent means of valuing benefits. Other means of valuing benefits fail to recognize that there can be wide disparity among plans in benefit delivered based on market factors, plan design and delivery method.

d. Provide an exemption to Section 89 which recognizes that in some organizations there may be a heavy concentration of rank-and-file employees numbered among the highly compensated merely because there is exceptional workload at some point in time and the employer decides to conserve scarce benefit dollars by electing to pay substantial overtime rather than to hire additional employees.

I want to thank you for providing this opportunity to plead Los Angeles County's case for further amendment or repeal of Section 89. Again, if I can be of any further assistance in your continuing consideration of this matter, do not hesitate to call on me.

9:vp.1/.2

Mahrt & Associates, Inc.
Administrative Services

July 19, 1988

Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test", because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization--as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex--yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated" but who are now in a position where they hae to provide their non-discrimination according to nearly incomprehensible standards--you should consider the following alternatives::

- Repealing Section 89;
- Delaying Section 89's effective date to atleast a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives;

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Janet

Janet Schoessler
Oregon Operations Manager

MANN
THEATRES
A DIVISION OF CINAMERICA THEATRES, L.P.

COMMENTS ON PART OF THE RECORD OF JULY 13, 1988
HEARING ON SENATE BILL S2238

Mann Theatres Corporation of California fully support Congress' goal of preventing discrimination in employer provided health and group-term life benefits. But Section 89 has transformed this goal into a complex web of administrative requirements exceeding the capabilities of most employers. Unless Congress acts, this complexity and lack of timely regulatory guidance will drive many employers to simplify their plans to ease their compliance burdens. The likely changes -- reduced health benefit option and cutbacks to subsidize family health coverage -- will result in less benefits to the very workers Section 89 seeks to protect.

We therefore urge Congress to delay Section 89's effective date to provide a realistic schedule for employer compliance -- no less than 12 months lead time following issuance, in final form, of all regulations necessary to apply Section 89. We further urge Congress to use this delay to enact major simplifying changes to Section 89.

MANN THEATRES CORPORATION
OF CALIFORNIA

Ken Crowe
Senior Vice President

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STATEMENT OF McGLADREY & PULLEN
IN SUPPORT OF S.1239
BEFORE

SUBCOMMITTEE ON TAX AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
JULY 19, 1988

We strongly favor S.1239 or comparable legislation. This bill removes an obvious oversight in the technical corrections to the 1984 Tax Act which were part of the Tax Reform Act of 1986. The amendment to IRC Section 1281 was intended to prevent avoidance of the requirement that interest on discounted obligations be accrued. The language of the statute was changed in a manner to require banks to accrue interest income on all short-term obligations regardless of the potential for the abuse targeted by the legislation. This is true even though small banks were excepted from accrual basis accounting by another bill provision of the same tax act.

The committee reports associated with the change did not in any way suggest that the technical correction was intended to change the accounting for interest on loans made by banks in the ordinary course of business. Furthermore, it is hard to imagine under what circumstances such loans could be used to avoid the provisions of IRC Section 1281 as it existed prior to this technical correction.

S.1239 should be enacted to remedy the inequities caused by the overly broad language of Section 1281, as amended in 1986, for many reasons including:

1. The mandatory change of accounting method from cash to accrual for interest income, is inconsistent with the exemption from accrual basis accounting allowed to entities with less than $5,000,000 of gross receipts.

2. For banks with most of their customer loan portfolio comprised of short-term loans, the tax cost of accruing of interest on short-term loans can exceed the tax cost of full conversion to accrual basis accounting. This is true because no accrued expense items offset the accrued interest on the short-term loans.

3. Typically, taxpayers who are required to change their method of accounting are eligible to spread the income attributable to the change over a number of years. The accrual of interest on the short-term loans is included in income immediately or even retroactively without the benefit of the four-year spread of the income allowed for a required change to accrual basis accounting.

4. Accrual of interest on short-term loans (i.e., loans with a maturity of one year or less) is inconsistent with the treatment of interest on loans with maturity of more than one year and demand loans. A taxpayer using the cash method of accounting is not required to accrue interest on these other obligations. What policy reason could there be to require accrual of interest on loans with maturities of one year or less and not on other loans?

5. Because of the anomaly created by the requirement described in 4 above, similar taxpayers will incur significantly different tax liabilities from very similar economic results, simply because of slightly different business practices with respect to establishing maturity dates on customer loans. This type of arbitrary distinction between similarly situated taxpayers without apparent policy reason undermines confidence in the integrity of our tax law.

6. The artificial distinction between loans with a maturity of one year or less and loans with a maturity of more than one year has the potential to encourage bad banking practices. It is possible that a bank will extend credit for a longer period than good business practice would dictate because of the different tax treatment for loans of longer maturity. We believe that decisions as to the length of a loan should be tax neutral.

We congratulate you on considering this corrective legislation, which will return consistency to the tax accounting rules for interest accrual. As indicated above, we strongly support passage of this legislation.

STATEMENT OF
MEMORIAL SLOAN-KETTERING CANCER CENTER
BEFORE THE SENATE FINANCE COMMITTEE
REGARDING SECTION 457 OF THE INTERNAL REVENUE CODE

Memorial Sloan-Kettering Cancer Center ("Memorial Sloan-Kettering" or "Center"), a privately operated, nonprofit institution for cancer research and treatment, submits this statement in response to the Internal Revenue Service's ("IRS") recent interpretation that, under Section 457 of the Internal Revenue Code ("Code"), employees of nonprofit institutions will be taxed on nonelective deferred compensation when "there is no substantial risk of forfeiture", rather than when the income is paid or otherwise made available. Memorial Sloan-Kettering believes that this position is ill-advised, as it will severely limit the ability of not-for-profit institutions, like Memorial Sloan-Kettering, to maintain the current caliber of personnel without imposing significant financial restraints on the Center's research activities.

Senator Moynihan, recognizing the inequity of the IRS interpretation, has proposed to overrule it through his bill S. 2480, which exempts from application of Section 457 the nonelective deferred compensation plans provided by nonprofit institutions. Memorial Sloan-Kettering strongly supports this proposal, and requests that the Senate Finance Committee incorporate it into the pending technical corrections bill.

Founded in 1884, Memorial Sloan-Kettering is the oldest and largest privately operated center devoted exclusively to cancer treatment, research and education. The Center is comprised of two operating organizations: Memorial Hospital, the base for the center's clinical activities, and the Sloan-Kettering Institute, the principal base for laboratory research. Since its inception, Memorial Sloan-Kettering has been recognized for its use of innovative methods and technology in the effort to control and cure cancer. Currently, Memorial Sloan-Kettering is one of a select group of centers designated by the National Institutes of Health to test experimental drugs in the treatment of patients with AIDS. In addition, the New York State Department of Health has designated the Center a demonstration site to evaluate the efficacy of magnetic resonance imaging (MRI) units in diagnosing cancers.

Memorial Sloan-Kettering is continually refining traditional therapies, as well as exploring new ones. In this vein, scientists have made significant inroads in devising new techniques for surgery, radiation therapy, chemotherapy and combined uses of these modalities. For example, recent research efforts have focused on innovative methods for planning and delivering radiation therapy; developing new agents that are active against drug-resistent tumor cells; and applying sophisticated techniques of microvascular surgery that facilitate more effective reconstruction. In the forefront of cancer research, the Center is also working with monoclonal antibodies, biological response modifiers and cytodifferentiation agents in an effort to provide more cures for cancer patients. The Center is also investigating the ways in which normal cell behavior is regulated, so as to discover the precise nature of the genetic base of cancer and thereby identify means of interrupting the malignant process.

Critical to all of these advances, however, is Memorial Sloan-Kettering's ability to recruit exceptional staff members. To do so, the Center must compete with other major institutions across the country, both for-profit and not-for-profit. As part of the competitive package, Memorial Sloan-Kettering, like other nonprofit institutions, relies on its current ability to offer top administrators, researchers and physicians the same types of benefit plans provided by private for-profit organizations. If the Center is to continue its programs in the prevention and treatment of cancer, it must be able to offer its staff compensation packages that are at least closely comparable to those available in the for-profit sector.

Currently, Memorial Sloan-Kettering's staff in the areas of patient care and laboratory research represents the best in the medicine and science of cancer. In the past year alone, new appointments and promotions have strengthened and broadened the Center's patient care and educational programs. The Center has also strengthened its programs in basic and clinical research with the recruitment of several outstanding clinicians and scientists. Memorial Sloan-Kettering's professional staff, which includes internationally known physicians and scientists, leading investigators, and others with a broad range of expertise, experience and demonstrated achievement, is the single most important factor in determining the effectiveness of the Center's programs.

To retain these qualified personnel, as well as to continue to attract new staff members, Memorial Sloan-Kettering must be able to offer these highly sought after individuals competitive compensation packages. Yet IRS' position will severely disadvantage the Center's ability to do so by inappropriately placing nonprofit institutions at a competitive disadvantage with regard to for-profit facilities. Inevitably, application of the IRS' current interpretation will also threaten the extent and the quality of Memorial Sloan-Kettering's critical research and treatment.

The House Ways and Means Committee, in its Technical Corrections Act of 1988 (H.R. 4333), has considered the concerns raised by the current IRS interpretation. As approved by the Ways and Means Committee, the House provision would repeal application of Section 457 to non-profit institutions. We request that the Senate Finance Committee, when it considers technical corrections legislation later this year, incorporate the House provision.

Memorial Sloan-Kettering appreciates the opportunity to testify on this issue of critical importance. If we are to win the fight against cancer, it will only be through the talents and efforts of our highly qualified physicians and scientists, and the tax laws of the United States should not hinder our ability to attract and retain them.

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

July 13, 1988

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN
NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

BEFORE THE SENATE FINANCE COMMITTEE
ON NECESSARY TECHNICAL CORRECTIONS
TO CLARIFY AND RATIONALIZE
THE TAX TREATMENT OF MULTIEMPLOYER PLANS

My name is Robert A. Georgine and I am testifying in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized shortly after the passage of ERISA in 1974, to represent the interests of the more than nine million men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 170 pension funds, health and welfare funds, and related international unions.

I want to take this opportunity to bring to your attention several recently-enacted and proposed legislative provisions that create very serious, and, we believe, largely unintended, problems for multiemployer pension and welfare plans. We urge you to correct these problems in the pending technical corrections bill.

1. Necessary Technical Correction to the Pension Plan Full Funding Limitation Changes Made in the Omnibus Budget Reconciliation Act of 1987 (Act).

Section 9301 of the Act amended the full funding limitation set forth in Internal Revenue Code ("Code") section 412(c)(7) and Employee Retirement Income Security Act of 1974 ("ERISA") section 302(c)(7) to add a new full funding limitation equal to the excess over the value of the plan's assets of 150 percent of the plan's current liability. Current liability is to be determined based on interest rates that reflect current annuity purchase rates and fall within a range linked to recent interest rates on long-term Treasury bonds. The purpose of this change was to prevent abusive tax-motivated overfunding of pension plans. This type of abuse does not occur in multiemployer plans.

The imposition of this new full funding limitation on multiemployer plans is particularly inappropriate, because multiemployer plans -- which are not subject to the funding requirements in new Code section 412(l) -- continue to use pre-Act actuarial assumptions for all other plan funding purposes. Multiemployer plans tend to use relatively conservative funding assumptions, because those plans can be highly vulnerable to short-term fluctuations.[1] Under current conditions, the interest rates called for to set the new full funding limitation are substantially higher than the rates that substantially all multiemployer plans use for plan funding.

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[1] Employer contributions to multiemployer plans are fixed in labor contracts that run for several years, so they cannot be adjusted to match changes in plan funding needs in the interim. They are also typically based on some measure of the level of covered work by plan participants (e.g., cents-per-hour).

This could cause a multiemployer plan to find that contributions otherwise needed to meet minimum funding would not be currently deductible. If a plan increases benefits to keep contributions within the full funding limit in one year, the contribution rate fixed in the bargaining agreement may not be enough to cover the resulting funding requirements in following years, based on assumptions used for minimum funding purposes. Since contributions are contractually set for a multi-year period, they cannot be modified from year to year in response to fluctuations in the full funding limit. And in those cases where the benefits as well as the contributions are fixed in the bargaining agreement, there would be no solution short of annual collective bargaining, which would take an unacceptable toll on labor-management relations.

The current spread between the market-based interest rate called for to determine the new full funding limit and the rates multiemployer plans generally use for funding purposes is a very serious problem. Of even greater long-term consequence for multiemployer plans, however, is the fact that, because the full funding limit rate will vary from year to year in accordance with financial market conditions,[2] a significant element of instability has been introduced into multiemployer plan funding arrangements. If it is virtually impossible to predict with any assurance what the deduction limits will be over the life of the bargaining agreement, it will be comparably difficult for the union and employers to negotiate a contribution level that will assure both current deductibility and continued sound plan funding while the agreement is in force.

It is important to note that contributing to a multiemployer plan creates no opportunity for an employer to manipulate taxes. All multiemployer pension contributions are the product of labor negotiations. An employer with a contractual contribution obligation cannot vary the amount it pays from year to year to suit its year-to-year tax situation. Moreover, the pension contributions represent part of the negotiated compensation package. It has long been recognized that employers are generally called upon to spend the same amount on compensation in some other form, if it does not go into the pension plan.

Amounts contributed to multiemployer plans are held solely for the benefit of the covered employees, the overwhelming majority of whom are union-represented rank-and-file workers. As the law does not allow surplus multiemployer plan assets to revert to any contributing employer, a company that contributes more than is needed for plan benefits has lost the use of that money forever. Since more dollars into the pension fund generally mean fewer dollars for wages, health care or other benefits, the union's constituency also loses if the plan is overfunded. Thus, neither the union nor the employers have any incentive to maintain artificially high multiemployer plan contribution rates.

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[2] The rate must be within 10% of a four-year moving average of Treasury long-term bond rates, with the most recent experience to be most heavily weighted. But within that range, the interest rate must reflect current market prices for insurance company annuities.

Perhaps more important, applying the new rule to multiemployer plans will not likely serve any revenue-raising purpose. In a multiemployer situation, the employer cannot stop contributing, regardless of the full funding limit, without violating its labor contract. Faced with a deduction crisis, some plan boards of trustees will increase benefits in order to increase the deduction limit. Indeed, a recent survey of approximately 25 percent of all multiemployer plans in the country, conducted by a major pension consulting firm, showed that, for the four years 1984 through 1987, over 97 percent of all multiemployer plans that had a full funding limitation issue resolved that issue in a way that gave rise to absolutely no increase in taxable income either to contributing employers or to plan participants. Such a response to the short-term market fluctuations that will determine the limitation could, in some cases, create a continuing need for higher employer contributions over the long term, and correspondingly high tax deductions. Rather than helping to meet federal deficit reduction goals, in a multiemployer plan context, applying the change in the limitation to employer plans could hamper federal deficit reduction goals if the plans are forced to increase future employer costs to pay for current benefit increases.

A unique characteristic of multiemployer plans is the fact that, if they have unfunded vested benefits, they must impose a charge on withdrawing employers equal to the employers' share of the unfunded plan liabilities. The valuation of vested benefits for purposes of withdrawal liability is a responsibility of the plan's actuary. Many plans are using interest rates for this that are based in part on the interest rates prescribed by the Pension Benefit Guaranty Corporation for terminating single employer plans. Many others are using the same rates that they use for ongoing plan funding.

Few, if any, multiemployer plans are using withdrawal liability interest rates that are as high as the lowest interest rate allowable for determining current liability for plan years beginning January 1, 1988. Thus, some plans will find that, although they have withdrawal liability, the employers cannot contribute enough to eliminate it without exceeding the full funding limit. Others may find that benefit increases needed to enable employers to deduct currently the negotiated contributions that they are bound to make will create withdrawal liability where none existed.

Finally, we note an especially onerous and unfair consequence of applying last year's change in the full funding limit to multiemployer plans: the fact that it applies to all years after 1987. This gave no advance opportunity for employers and unions sponsoring multiemployer plans to take the change into account in arriving at negotiated contributions rates. Contributions that were clearly deductible when agreed to, which employers are now paying because they are legally bound to do so, may in fact now not be deductible. The employers cannot change what they contribute unless the bargaining agreements are reopened, which tends to be extremely disruptive of labor relations. As an alternative to protect the deductions, some boards of trustees might be pressured to adopt benefit improvements that could prove difficult to support in future years. Legislative relief from this dilemma is clearly needed.

For all of the above reasons, we urge you to provide, in a technical correction to section 9301 of the Act, that multiemployer plans are not subject to the new part of the full funding limitation. We suggest that this could be done by adding the following subparagraph at the end of Code section 412(c)(7) and ERISA section 302(c)(7):

"(E) Multiemployer Plans. -- Subparagraph (A)(i)(1) shall not apply to a multiemployer plan."

2. Health Care Coverage Continuation Requirements of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA").

The House Ways and Means Committee is currently marking up a proposal ("Proposal"), to be included in H.R. 4333 that would revise the sanctions for violations of the health care continuation coverage provisions of COBRA. Instead of current law sanctions, an excise tax would be imposed. The Proposal would make a multiemployer plan liable for all COBRA violations in which it is involved. The employer of the employees with respect to whom the violation occurred would also be made jointly and severally liable with the plan. However, the employer would not be liable for the excise tax if it had a written agreement with the plan that the plan would be responsible for the particular COBRA duty with respect to which the violation occurred. Under the Proposal, the multiemployer plan document may constitute the written agreement necessary for the safe harbor rule. This is very important to make the safe harbor workable for multiemployer plans.

We understand that a similar proposal may be included in the Senate version of the Technical Corrections Bill. We would like to suggest the following necessary modifications to make the Proposal more workable for multiemployer plans.

a. Employer Responsibility to Provide Notices of Termination of Employment, Reduction of Hours or Death of an Employee.

Multiemployer plans often have hundreds of contributing employers. These employers make contributions to the plan pursuant to collective bargaining agreements. Indeed, in many of the industries characterized by multiemployer plans (e.g., construction and longshore), it would often be impossible to provide employee benefits on any basis other than through multiemployer plans because participants may work for several different employers in the course of a week -- or even a day -- and the employers themselves are often small and fluid in structure. There is often little contact between individual employers and the plans' trustees.

Employers have neither the right nor the opportunity to oversee day-to-day plan administration such as COBRA implementation. Nor do they have unfettered discretion to withdraw from the plans. Multiemployer plans could be severely disrupted if employers could not continue to rely on the fact that the plan complies with all of its obligations, including its obligations under COBRA. Contributing employers have even less authority or opportunity to see that other employers comply with their COBRA obligations.

As a practical matter, an employer satisfies its obligations under COBRA if it provides the plan administrator with timely notice of a qualifying event based on an employee's death, termination of service or reduction in hours, as required by statute and regulations, and provides any required alternative coverage for qualified beneficiaries in the event that it withdraws from the multiemployer plan. It must rely on the plan (and the other employers) to satisfy all other COBRA requirements.

The Proposal would resolve this problem with respect to contributing employers, because it would establish a procedure for the plan to be responsible for COBRA compliance matters over which the employers have no control. However, the plan should have a similar opportunity to establish that the employer is solely responsible for giving the qualifying event notice to the plan administrator regarding employees' death, termination of service or reduction in hours. Plan administrators need that notice, in many cases, to follow through with the prompt delivery of COBRA elections and coverage.[3] In such circumstances, it makes no sense to impose a tax on the plan, which needs, but cannot get, this necessary information. Instead, the excise tax should be imposed solely on the employer, who would thus be encouraged to provide timely and accurate notices to the plan.[4]

Finally, in some multiemployer plans, an entity may contribute to the plan on behalf of the employees of a contractor that does work for the entity. In these circumstances, it is the contractor, and not the contributing entity, that is likely to know when an employee terminates service or dies. Accordingly, it is important in such circumstances for the plan to be able to impose on that contractor an enforceable obligation to provide necessary notices to the plan administrator. In such cases, where plan rules so provide, the contractor should be made jointly and severally liable with the contributing entity.

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[3] In some multiemployer plans, because of the nature of their particular industries, it may be more workable for the plan administrator to waive the requirement that employers send specific notices whenever an employee completes a job, and treat the employee's loss of plan eligibility from any source as the qualifying event. However, in other industries, the employer notice approach will be more workable. In such industries, multiemployer plans should have an enforceable mechanism for requiring employers to provide necessary notices.

[4] We have previously submitted comments to the Tax and Labor Committees relating to notice requirements to ensure that qualified beneficiaries with respect to whom an employer has failed to notify the plan will be promptly provided with their COBRA rights whenever -- and however -- they are brought to the plan's attention.

b. Employer Responsibility for Coverage After Withdrawal.

The obligation to provide COBRA continuation coverage is an obligation of the employer. Once an employer has withdrawn from a multiemployer plan, the multiemployer plan's relationship with that employer is similar to the relationship an insurance company has once an employer terminates its policy with the company. The multiemployer plan therefore has no further obligation to that employer's employees or their qualified beneficiaries. Instead, the employer is obligated to provide any required continuation coverage under one or more of its other plans, if any. This point should be made clear in legislative history, if not in the statute.

3. Welfare Plan Nondiscrimination Rules.

We urge you to permit employers contributing to multiemployer welfare plans to treat the amount of their contributions to such plans, with adjustments, as the value of the welfare benefits provided. Such employers typically make contributions to such plans pursuant to collective bargaining agreements, which require them to contribute a certain number of cents per hour or other measure of work. The plans' labor-management boards of trustees establish the plans' benefits, eligibility and coverage rules, financing, and other matters. The individual contributing employers, often numbering in the hundreds, ordinarily have no involvement with the plans' operations and little information about plan benefits, or even which of the employees with respect to whom they contribute are actually covered.

Such employers therefore typically do not have the information necessary to value coverage provided to specific employees. Accordingly, we are greatly encouraged that the staff of the Joint Committee on Taxation has proposed, and the Ways and Means Committee has apparently adopted, a rule clarifying that, in applying the Section 89 nondiscrimination rules, the value of an employee's coverage under a multiemployer plan will be treated as equal to the amount the employer contributes with respect to that employee. We would like to suggest a few refinements to make this concept more workable.

Multiemployer plans could be required to inform employers, upon request, of the portion of the bargained-for contribution that is allocable to each different type of benefit -- health, group term life, etc. This would be determined based on clear, simple, and objective guidelines promulgated by Treasury. In addition, special rules of convenience must be developed to "normalize" contributions made on behalf of short-service employees and special situations in which the basis for contributions is not directly related to the periods worked by employees, or in which contributions are made by companies that do not employ the plan participants. All employees with respect to whom an employer contributes at the same rate should be treated as covered by the same "plan." In addition, the ability of employers to exclude any category of "excludable" employees for purposes of section 89 testing should not be affected by the inclusion of some such excludable employees in a multiemployer plan. In addition, the welfare plan reporting requirements of Code section 6039D must be modified if they are to be workable for multiemployer plans.

We also suggest that employers that have the capacity to do so be permitted to value benefits provided under multiemployer plans under the general rules, rather than the contribution-based approach.

We will submit more detailed comments to your staff and look forward to working with them to resolve these important issues.

4. Welfare Plan Reserve Limits.

The Deficit Reduction Act of 1984 imposed limits on reserves of welfare benefit plans. Employer contributions that increase plan reserves above these limits are not deductible. Income of these plans that increases reserves above these limits is subject to Unrelated Taxable Business Income Tax ("UBTI"). The Tax Reform Act of 1986 provided an exception to these reserve limits for collectively bargained plans.

It is important to clarify that: (1) The collectively bargained plan exception, permitting all deductions to such plans to be deductible, and all reserves of such plans to be tax-exempt, applies to all types of welfare plans, including, for example, group legal and educational assistance plans, and not just to medical, disability, life, SUB and severance plans; (2) the exception applies regardless of whether the contributions are used to purchase "facilities" such as computers, a building, office furniture, etc.; and (3) the UBTI tax is not imposed on post-retirement medical benefit reserves of collectively bargained plans.

5. Group Legal and Educational Assistance Sunsets.

As I discussed in detail in my March 28, 1988, testimony before the Subcommittee on Taxation and Debt Management, it is important to make permanent the exclusions from employee income for employer-paid group legal and educational assistance benefits, which expire after 1987. These plans provide important benefits for working Americans. The tax and administrative burdens that would arise in the absence of the exclusions would likely force most of these plans to be terminated.

6. Bifurcation of Plans.

There has recently been a very serious trend to bifurcate special rules and effective dates applicable to multiemployer and/or collectively bargained plans. Thus, the special rules are applied only to those individuals covered under the plan pursuant to a collective bargaining agreement, and not to any individuals that may be covered under the plan on any other basis. Statutory examples include the Code section 411 ten-year vesting exception for multiemployer plans and the following effective dates: $7,000 limit on elective deferrals (TRA § 1105(i)); minimum coverage and additional participation requirements (TRA § 1112(e)); minimum vesting standards (TRA § 1113(e)); minimum distribution requirements (TRA § 1121(d)); and nondiscrimination rules for coverage and benefits under certain statutory employee benefit plans (TRA § 1151(k)). In addition, proposed Treasury regulations apply the COBRA health care continuation coverage rules on a bifurcated basis. Even worse, those regulations treat bargaining units that join a plan after April 7, 1986, as if they were not collectively bargained, for purposes of the effective date provisions. As a practical matter, in most cases, such bifurcation renders the special rule or extended effective date unusable by multiemployer plans.

We urge you to apply these and all special rules and effective dates applicable to multiemployer and/or collectively bargained plans to the entire plan, provided that the percentage of plan participants who are covered pursuant to a collective bargaining agreement is sufficiently high to justify characterizing the plan as collectively bargained.

7. Other Technical Corrections.

In addition, there are a number of other multiemployer plan changes that should be included in the pending Technical Corrections Bill. We have made submissions and presented testimony and are working with staff on these issues, which relate to: ten-year vesting; proposed changes in required frequency of pension plan valuations; pension plan nondiscrimination rules; the treatment of life insurance contracts as death benefits; joint and survivor annuity rules; effective dates; section 415 limits on contributions and benefits under qualified plans; and a proposed repeal of the current law provision terminating COBRA coverage when an individual becomes covered by another group health plan.

* * *

If you have any questions, or if we can be of further help on any of these issues, please call Vivian H. Berzinski (872-8610) of our professional staff.

STATEMENT SUBMITTED BY THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Finance Committee

Subject: Technical Corrections Issues
Section 89 of the IRC, COBRA Amendments

Date: July 12, 1988

On behalf of the more than half million independent business owners who are members of the National Federation of Independent Business (NFIB), we submit the following testimony on two key issues of concern to NFIB members contained within the technical corrections legislation to be taken up by this committee.

Section 89 of the Internal Revenue Code

Background

The Tax Reform Act of 1986 (TRA) included a revision to section 89 of the IRC. Essentially this section will now require that the non-discrimination tests which apply for pension plans under the Employee Retirement Income Security Act of 1974 (ERISA) will now apply to the qualification of health, welfare, and fringe benefit plans.

Under section 89 all employers must test each fringe benefit plan and each separate set of options under a fringe benefit plan to determine if the plan meets the new definition of non-discrimination. Failure to meet these new qualifications will result in the taxation of most benefits received by the owners or highly compensated members of the plan.

Small Business Concerns

When is a Mandate a Mandate?

Congress has spent a substantial amount of time discussing the pros and cons of mandated benefits in the areas of health care, child care, parental leave. Congress has yet to underwrite any specific action in this area, as there are many issues to be debated and considered.

Yet, Congressional changes to section 89 of the IRC in 1986, if interpreted as broadly as the Joint Committee on Taxation and the Treasury Department advocate, will result in Congress mandating benefits.

While some say that the mandate will only occur in a situation where the employer's benefits plan discriminates against lower-paid employees, in fact section 89 creates a new definition of discrimination.

The new rules draw lines which very few small business owners can measure up to, creating a new definition of discrimination that is based on a lack of coverage rather than on eligibility. In crafting this new test, Congress did not take into account two primary small business issues, that of affordability and compliance.

When compared on a basis of cost per employee, the cost to a small business owner for health insurance coverage is higher than that for a large business. These higher costs translate into limited flexibility by a small business owner in the variations of coverage he can provide to his employees.

Under the new section 89 rules, a small employer who provides health insurance coverage for employees, but who requires his employees to share costs when dependents are covered, can find the plan deemed discriminatory and thereby disqualified for reasons outside the employer's control.

Imagine the small employers of this country waking up on January 2 of next year and being told that the health plan which was fair and equitable two days ago is now discriminatory against his/her employees.

The typical NFIB member generates a mere $350,000 per year in sales. He/she is facing ever-increasing labor costs and yet is trying to work with employees to provide them some measure of protection against illness. However, Congress has decided that the employer will not have such discretion and that nothing less than a mandate will do.

Additional Paperwork and Compliance Costs

Each separate set of options will require a separate set of tests to be applied. The high option coverage is one plan, the low option coverage is another plan, the dependent coverage is a third plan, supplemental coverage is a fourth plan.

Each plan requires the employer to test continuously to determine if the plan qualifies under section 89. All this adds up to increased compliance costs, increased paperwork costs, increased costs of coverage. This cannot realistically be perceived as an incentive for employers on the edge of financially affording health insurance coverage for their employees to purchase such coverage.

Lack of IRS Regulations

Clearly the new paperwork (and compliance) requirements are going to be difficult for most small employers to integrate into their management systems, especially since most accountants and attorneys have yet to advise their clients on these new requirements. In addition the IRS has yet to issue any clear guidance on how employers are to comply with the new provisions.

Some safe harbor tests, or some protection against adverse selection problems, is clearly warranted on behalf of small employers. Additional time for small employers to become familiar with yet-to-be published IRS regulations is clearly warranted, too.

EXTENSION OF COBRA BENEFITS

Change in Termination Rule

Small business is about to be bitten by an expansion of the infamous COBRA provisions. First enacted in 1985 under the Consolidated Omnibus Reconciliation Act (hence the acronym COBRA), these health insurance requirements were enacted without the benefit of hearings or input from the business community.

Apparently the snake is being let out of the bag again. The technical corrections bill, introduced as S.2238, contains an expansion of the COBRA rules. Under the original provisions enacted in 1985, COBRA benefits terminated when a former employee became eligible for health insurance coverage by a new employer. The technical corrections bill includes an expansion of COBRA by removing the automatic termination rule if the former employee or a dependent is unable to qualify under the new employer's medical plan due to a pre-existing medical condition.

Calling this a simple technical correction is a specious argument. The Finance Committee has requested general comment on the technical corrections legislation, but no hearings or review of this issue have been conducted. Certainly no committee has held any hearings to explore the adverse cost impact this type of rule could have on a small employer.

If enacted, this new COBRA rule will have a serious impact on some small employers. Their benefits plan costs will rise, as will the employers' subsequent experience ratings and future plan costs. Increased costs to provide the same coverage will impact the employers' ability to expand or maintain current benefit plans for his current employees.

Data From 1985 Employee Benefits Survey

It would be helpful at this point to reiterate some data from previous NFIB testimony on small employers' health insurance costs and coverage.

The primary basis for our remarks come from two national surveys we have conducted in this general area. The first survey was done in 1978 and is entitled National Health Insurance Report on Small Business. The second, conducted in late 1985, is entitled Small Business Employee Benefits.

Coverage Among Small Firms

Small firms are not unlike their larger counterparts in recognizing the value of employer-provided health benefits. The number of small business owners providing employee health insurance has been rising as the ability to pay for these benefits increases.

According to our national survey in 1985, sixty-five percent of firms offer health insurance for at least some full-time employees, an increase of eight percentage points from a similar finding in 1978. Forty-two percent of small firms provided health insurance to all full-time employees. Subsequent field survey data from April 1987 indicate as many as seventy-five percent of those who provide fringe benefits are providing health insurance. This, despite the fact that in 1985, the median monthly health insurance premium paid by small employers was over $1,766, more than double the monthly premium paid in 1978. The rising cost of health insurance is the number one problem as reported in NFIB's 1986 Small Business Problems and Priorities study.

The vast majority of firms in all size categories offer plans that include hospitalization/surgical and major medical. In the aggregate, nearly two-thirds of these employers pay the entire premium cost, with smaller firms more likely to pay 100% of the premium than larger firms. Well over eighty percent of health insurance plans offered in small firms carried an option for dependent coverage.

Employee health insurance was not provided by about one-third of small employers. No single reason dominated their decisions. The most frequently cited reasons were: employees covered under a spouse or parent policy (secondary wage earners); premiums were too high; employee turnover was too great; the firm's profitability was insufficient; or the firm couldn't qualify for a group policy. There is a fringe benefit hierarchy for small employers. Paid vacations are provided first, with health insurance becoming available as the firm matures and begins to make a profit.

In their May 6 testimony, the Health Insurance Association of America outlined three primary reasons for higher premiums for small employers:

1) higher acquisition (marketing and underwriting) and fixed administrative expenses which must be recovered from a smaller number of employees;
2) the behavior of small business in the marketplace, i.e. lower renewal rates and adverse selection; and
3) government regulations, particularly state-mandated benefit laws.

NFIB evidence would support much of their reasoning -- evidence accumulated through our benefit surveys and firsthand experience in launching our own group medical insurance program, the details of which we will share with you later in our testimony.

Review of these facts and the extensive results of our employee benefit surveys lead NFIB to believe that small employer-sponsored health care plans can best be expanded by:

1) reducing health insurance costs by reducing or eliminating state and federal mandates;
2) expanding the health insurance premium income tax deduction for unincorporated businesses;

3) offering more realistic tax incentives to small firms; and

4) encouraging the further development of group plans and multi-employer trusts (METs).

Tax Incentives

Tax incentives for health insurance have encouraged the spread of private coverage, protecting people from financial hardship and the public from carrying their burden. The United States will forgive about $35 billion in taxes owed in 1987 to provide this protection to about 146 million people.

The federal tax code has, since 1954, provided a double subsidy for health insurance bought for employees by employers. The employer's taxable income is reduced by the amount of health insurance premiums paid, and the employee doesn't have to include the dollar value of the insurance in his or her income. Despite this strong commitment to encourage businesses to provide health insurance through tax incentives, small unincorporated business owners have never been afforded the same privilege as their corporate counterparts.

The Tax Reform Act of 1986 made some movement in rectifying this unequal treatment by allowing a 25 percent tax deduction for health insurance premiums paid by unincorporated business owners.

Forty-two percent of these business owners have no health coverage. Sixteen percent of all uninsured workers in 1985 were self-employed. Health benefits can and should be expanded to these owners and their families by extending them an equal 100% health premium tax deduction.

Income tax deductions to purchase health insurance are an ineffective incentive for new and marginal firms. If you're not making money, there's nothing to take a deduction against.

A more viable tax incentive would be a deduction against payroll taxes. From the first dollar they pay in salary -- even to themselves -- small business owners pay payroll taxes, and to be of any real value, the incentive must be against a tax they pay.

For our members, payroll taxes aren't just another cost of doing business. Payroll taxes, for a majority of small firms, constitute more of a burden than any other form of taxation. Today, nearly one of every three federal tax dollars collected is a payroll tax, and this burden remains a constant threat to small, labor-intensive firms. NFIB recommends that the committee explore payroll tax credits as a viable incentive for expanding small employer health care coverage. We believe this kind of encouragement could go a long way in providing coverage for many marginal employers and their workers.

Group Plans

Our surveys show that small business owners purchase private health insurance from a great variety of carriers. While the firm was the group sponsor more often than not, trade/business associations have been increasingly taking that role, including NFIB.

Recognize that, indeed, many small employers themselves would be considered marginal at best. The 1983 median annual earnings for full-time business owners, men and women respectively, were $15,600 and $4,984. This compares to male and female employees, $20,039 and $12,079 respectively (according to the Monthly Labor Review, May 1987, U.S. Department of Labor, Bureau of Labor Statistics).

There are now more than 15 million small businesses in the United States, many of whom employ the young and old, women and minorities in larger proportions than our competitors in big business. Two-thirds of all American workers get their start in a small firm.

In 1985, the number of jobs nationally increased by 2.7%. The number of jobs in small business-dominated industries rose by 5.1%. These include construction, retail trade, and services (incidentally, those most lacking in health care coverage). During the same period, employment in large business-dominated industries rose by only seven-tenths of one percent (0.7%). Minority self-employment rose to an all-time high of 522,000, contrasted with 337,000 ten years earlier.

While we are making suggestions as to how coverage through small firms might be expanded, we must recognize that much of the problem is structural by nature. Federal mandates will only exacerbate the problem.

The economics of mandated benefits are pure and simple. If you legislate the cost of labor upward -- particularly, marginal labor for marginal firms -- less labor will be demanded and those jobs will start evaporating.

Ways and Means Committee Actions

The House Ways and Means Committee has reported out its version of technical corrections, proposing several "simplifications" to section 89. The recommendations of the House committee provide a starting point for the Finance

Committee, but in no way do the recommended actions solve the problem for small employers.

There is still a need for some form of safe harbor to protect employees while not penalizing those employers who do not sponsor discriminatory health plans, but who voluntarily provide equal benefits. A safe harbor is needed which allows a small business owner to qualify his benefits package but removes any excessive paperwork or recordkeeping burden.

A safe harbor which accomplished these goals would ensure continued provision by employers of health and fringe benefits for employees, without endangering the level of benefits the employer can afford to provide.

Section 89 as drafted will deliver this message to small employers:

> It's fine, Mr. or Mrs. small business owner, that you are helping your employees by providing some measure of health protection, but we (Congress) do not think this is enough. So to help you provide more benefits to your employees, we are going to penalize you.

At this point, Congress is making the determination to mandate a level of health benefits, as surely as if it enacted the most radical health legislation currently being proposed.

Small business owners object to this backdoor mandate. If the objective is fairness, we need to discuss a realistic definition of fairness. As the data from previous NFIB surveys illustrate, and as data from other non-profit non-partisan organizations have shown, many small business owners are doing as much as they can, voluntarily. Ensuring provision of adequate coverage cannot be accomplished merely by a mandate: practical limitations must be recognized. A comprehensive review of health care costs and needs is required for a more thoughtful approach to health care and all fringe benefit issues provided by employers.

I am not aware that such a debate was engaged in during consideration of the 1986 Tax Reform Act.

Specific Recommendations

- If the intention is to penalize employers who are discriminatory, the regulations under section 89 should be designed so as not to penalize those employers who do not truly discriminate.

- A safe harbor must be designed which does not result in an employer being penalized under a definition of "discriminatory" that itself discriminates against smaller employers.

- In crafting a safe harbor which works for employers with fewer than 15 employees, some manner of aggregating the value of all benefits to employees should be allowed as a way of reducing the number of tests and the degree of compliance the small employer must satisfy.

- Data collection rules must include a limitation on the number of times per year the small employer must gather the necessary data to comply with section 89.

- The definition of a part time employee as one who works at least 17 1/2 hours per week is arbitrary and has been formed without any prior debate. This needs to be modified.

- The requirement for a sworn statement from employees who do not elect employer-provided coverage places a burden on the employer which is unnecessary. Current law requires an employee to affirm that he has received all available information on fringe benefits from an employer and that he understands his options.

* The definition of a highly-compensated employee needs to be reviewed. Under the Ways and Means proposal, the requirement to qualify for the safe harbors includes a simplified method. However, the requirement also specifies "that the employer would not be entitled to this election if the employer maintains any "top heavy fringe benefit plans".

* The top heavy rules which apply in the pension categories by definition rule out all small employers from the simplified safe harbors. This definition needs to be removed from the safe harbor in defining highly compensated employees.

* Some realistic time frame must be provided small employers to allow them and their insurance carriers to adjust to these requirements.

Conclusion

NFIB asks this committee to carefully consider some positive changes to section 89 of the IRC. Congress must consider the impact of section 89 within two criteria:

The need to nurture the ability of small business to continue to create jobs and economic opportunity; and the need to encourage small employers to provide the flexible range of fringe benefits which are responsive to the needs of the employees, free of government mandates.

In addition, we ask your help to postpone changes in the COBRA benefit rules and to provide an open forum to discuss options for expanding health care.

WRITTEN STATEMENT OF
THE NATIONAL GRANGE
Prepared by
Mark C. Nestlen, Legislative Representative
Submitted to
The Senate Finance Committee
July 13, 1988
RE: S. 2238, the Technical Correction Act of 1988

Thank you, Mr. Chairman, for the opportunity to submit testimony on S. 2238 (H.R. 4333), the Technical Corrections Act of 1988. The National Grange, the first general agricultural and rural organization, strongly supported passage of the Tax Reform Act of 1986. We believe that as a whole the new tax laws have and will continue to benefit the economy, particularly the agricultural economy. However, as with any major legislation, there were some drafting mistakes and a few content errors that desperately need to be corrected. On behalf of the over 365,000 members nationwide, we strongly encourage the Finance Committee to move forward with markup on the Technical Corrections Act of 1988. The remainder of this testimony will deal with specific provisions which should be addressed in that legislation.

PART I - PROVISIONS IN S. 2238 (H.R. 4333) AS INTRODUCED

Discharge of Indebtedness

The technical change for the treatment of discharge of indebtedness income of certain farmers (section 104(a) of the bill, section 405 of the Reform Act, and sections 108 and 1017 of the Code) is inconsistent with the Conference Report of the Reform Act. Farmers and taxpayers relied upon the Conference Report and the change in the technical corrections will be at their disadvantage. The Grange is concerned that this change could create confusion for producers and their tax preparers and, therefore, opposes the change.

Capital Gains for Dairy Termination Program

Section 104(b) of the bill (section 406 of the Reform Act), retention of capital gains treatment for sales of dairy cattle under the milk production termination program, corrects the drafting error made in the Tax Reform Act of 1986. However, the provision in the technical bill refers to a sale occurring under the program before October 1, 1988. The sale had to occur before September 1, 1988 by terms of the contract. Therefore, the Grange supports section 104(b) of the technical bill but recommends the date October 1, 1988 be changed to September 1, 1988.

Limitations on Farming Deductions

The Grange has contended that the 50 percent prepaid expense provision is unnecessary due to the rules of the Reform Act that require tax shelters to use accrual accounting, and the material participation rules. The technical change, limitation of the use of the cash method of accounting - limitations on farming deductions (section 108(a) of the bill, section 801 of the Reform Act, section 464 of the Code), only deals with the elimination of the prepaid provision for farming syndicates. The Grange believes this technical correction should be expanded so that section 464 shall not apply to all agricultural taxpayers who use the cash method of accounting.

Self-Employed Health Insurance Deductions

The National Grange disagrees with the proposed correction for the deductibility of health insurance costs of self-employed individuals (section 111B(b) of the bill, section 1161 of the Reform Act, and section 162(m) of the Code). The corrections bill would specify that the amounts deductible under section 162(m) do not reduce the income base for the self-employed individual's social security tax. We do not believe that it is equitable to allow employed individuals fringe benefits which do not add to the income base for social security purposes unless the self-employed can reduce their income base by the amount deductible under section 162(m). The purpose of this provision was to develop a level field between the employed and self-employed. This was only partially achieved since only 25 percent of health insurance will be deductible for the self-employed. The recommended change in the correction bill will only further tilt the scale in favor of the employed.

PART II - OTHER CORRECTIONS WHICH SHOULD BE IN S. 2238 (H.R. 4333)

Preproductive Period Expenses

Section 263A of the Tax Reform Act of 1986 forces livestock producers to capitalize the preproductive period expenses of raising livestock rather than allowing ranchers to deduct the expenses on an annual basis. This provision has been successful in creating confusion and turmoil across the country. Not only does this new capitalization requirement raise the cost of producing livestock (the National Cattlemen's Association estimates that production costs, via increases in taxes, could rise $50 to $100 per head), but it also is so complicated that universities and accountants are providing conflicting advice and may be leading producers in the wrong direction.

It is absolutely essential that the capitalization requirements for livestock, the so-called "heifer tax", be eliminated from the tax code. The repeal of the provision passed the House floor last year in the budget-cutting package but was removed in Conference since it was a technical correction to the Tax Reform Act. There are currently over 51 cosponsors in the Senate of legislation to repeal the capitalization requirement, and a repeal of the provision should be included in any technical corrections passed this year. (The repeal provision and a variation of the Grange's revenue offset is included in the technical bill as reported by the House Ways and Means Committee on July 14, 1988.)

A number of problems exist with the capitalization rule. First of all, the preproductive period is inaccurately defined. The preproductive period is defined as from conception of the animal until the animal gives birth. This definition is practically and technically incorrect. Under the "two gestation" definition, there are actually three distinctly different management periods. From conception to parturition, the management practices relate to the care of the mother. After birth until the female is placed in the breeding herd is a second stage of management. The management during this period relates to the growth and development of the animal itself. When the female is placed in the breeding herd, the care of that female is a production management and is similar to the care that her mother received during gestation. Therefore, the "true preproductive period" for livestock is from birth until placed in the breeding herd.

The Department of the Treasury listened to industry concerns prior to the development of regulations for the provision. However, the law was so specific that the Treasury Department could not use recommendations from the industry and succeeded in creating a nightmare.

The Treasury Department's regulations defined the preproductive period as follows:

> "The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The preproductive period ends at the time the animal is ready to perform the primary function intended to be performed by that animal (e.g., when the animal becomes productive in marketable quantities), or when the animal is reasonably expected to be sold or otherwise

> disposed of. For example, in the case of a cow used for breeding purposes, the preproductive period with respect to the cow ends on the date the first calf is dropped."

This rule, which was mandated by Congress, creates discriminatory situations between different types of livestock operators who use different management practices. Some producers could come in under the two-year period while their neighbor, due to a slightly different management practice, would fall outside the period. The following are a few examples.

A producer who sells calves will have an unfair advantage over a producer who retains calves for breeding purposes. If a rancher sells calves under the two-year deadline, the preproductive period expenses could be deducted while a rancher who retains heifers for the breeding herd would be forced to capitalize the same expenses.

Additionally, bull calves are determined to have a different preproductive period than heifer calves. Males do not have a second gestation period. This, then, indicates that the preproductive period for the male would end when he can impregnate a female - his intended function.

Furthermore, producers of protein food products other than beef and dairy are not affected by the provision and will not experience any changes in their cost of production. As cattle production costs increase, supply decreases which, in turn, raises the price of live cattle and beef. As the retail price of beef rises and other protein food source prices stay constant, a substitution affect will occur, precipitated by bad tax policy.

Horses are yet another concern. The IRS regulation talks of the intended function of the animal occurring when an offspring is produced. However, race horses, show horses, rodeo horses, etc. all perform their useful purpose prior to entering the breeding herd. It is unclear how this situation will be handled.

Another problem involved in this provision is the different depreciation schedule for producers who elect not to capitalize. Under (vi) Special rules for treatment of expenses (B), it states that:

> "If the taxpayer or a related person makes the election, the alternative depreciation system (as defined in section 168(g)(2)), shall be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect."

Once again, these regulations tilt the playing field, this time in favor of single commodity producers. While most farmers will be allowed to use a form of accelerated depreciation, a select few will be forced to use the straight line depreciation method on all the farm's assets simply because their operation is diversified - a recommended practice to avoid economic downturns.

The repeal of the capitalization requirements does have a cost. We propose to offset the cost by changing the depreciation method for agricultural assets. The Grange suggests that the depreciation method for agricultural assets be changed from the double declining (200 percent) balance method to the 150 percent declining balance method, and that single purpose structures be depreciated over 10 years rather than 7 years. Both changes are sound tax policy.

Changing the rate of depreciation does not reduce the overall tax benefit of the investment. It does reduce the amount of up-front benefits gained by the taxpayer. Changing the depreciation rate will reduce the incentive for an investor to purchase agricultural assets solely for the tax benefit gained by the first few years of depreciation. Moreover, this depreciation method will more accurately reflect the useful life of the asset. Lengthening the number of years single purpose structures are depreciated for from 7 to 10 years will more accurately reflect university studies which show 10 years is an accurate length for the life of single purpose structures.

Loan Loss Reserves

One provision of the Tax Reform Act of 1986 that indirectly places an unnecessary burden on our nation's family farmers is the provision that repealed the reserve method of accounting for loan losses for the institutions of the cooperative, farmer-owned Farm Credit System (FCS). The Grange strongly supports returning the use of the reserve method of accounting for loan losses to the FCS at the earliest possible date.

The FCS serves over 600,000 farmer borrowers and holds approximately 1/3 of all outstanding farm debt. Congress recently enacted the Agricultural Credit Act of 1987 specifically to provide assistance to the financially-troubled institutions of the Farm Credit System to assure this nation's farmers that adequate supplies of agricultural credit would be available to them at competitive interest rates. As a result of this legislation, $130 million in financial assistance has already been provided to specific System institutions.

The loss of the reserve method of accounting for loan losses contradicts, in two ways, the Congressional goal of assuring a healthy, competitive Farm Credit System. First, it is estimated that the loss of this provision will result in $90 million in additional tax liabilities for the FCS and its farmer borrowers. It seems inefficient to provide federal financial assistance to System institutions while at the same time increasing their federal tax burdens.

Second, the loss of the reserve method of accounting for loan losses places Farm Credit System institutions at a financial disadvantage in the agricultural credit marketplace to many of its competitors, such as commercial banks who continue to be able to use such accounting practices. The ultimate test of the viability of a system of farmer-owned cooperative Farm Credit institutions will not be the amount of federal assistance they receive but their ability to compete in the marketplace. Given the opportunity to compete for the farmers' borrowing business on a level playing field with other agricultural lenders, we believe that the FCS will be able to aggressively serve its borrowers while, at the same time, minimizing the need for direct financial assistance.

Family Attribution for Material Participation

The Tax Reform Act of 1986 provided certain restrictions on passive investment losses where a taxpayer did not "materially participate" in a trade or business activity. The use of agents to run day-to-day operations is allowed in the law. The Grange believes that a family member is a special type of agent. We suggest that the technical package clarify that for the purpose of the passive loss rules that activities of one family member be attributed to another. (The attribution should be limited to second generation family members and not be as broad as section 2032A.) Specifically, a taxpayer who "actively participates" in a farming activity should be attributed the activities of a family member for the purpose of determining if the taxpayer "materially participates". The definition of "farming activities" should be consistent with the definition of "farming purposes" in section 2032A. The term "active participation" should have the same meaning as otherwise provided in the Tax Reform Act of 1986.

PART III - CORRECTIONS TO OTHER TAX LEGISLATION

Diesel Fuel Tax

As a part of the Budget Reconciliation Act of 1987 (Title X, Subtitle E, Part I, Section 10502), Congress changed the point of collection for the diesel fuel excise tax from the retail level to the wholesale level. The effect of the provision is to require previously tax-free purchasers, such as farmers, to pay the diesel fuel excise tax at the time of purchase and then file for a refund either quarterly or annually based upon the amount of refund due. The National Grange supports repeal of this new law as of October 1, 1988. There are over 54 Senators who are cosponsors of legislation to repeal the diesel fuel tax provision, and the Senate Finance Committee has approved the repeal. The repeal provision should be contained in the technical package. (Repeal of the tax collection as of July 1, 1988 is contained in the technical bill passed by the House Ways and Means Committee on July 14, 1988.)

Since farmers and ranchers are exempt from the diesel fuel tax for off-highway use, it makes no sense to require payment of the tax and then have users file for a refund or tax credit. In a sense, the collection of the tax results in a mandated, interest-free loan from farmers and ranchers to the federal government since the government does not pay interest on the money held prior to the refund.

Higher interest costs and cash flow problems will undoubtedly result from the new tax collection procedures. Based on the 1982 Census of Agriculture, annual use of diesel fuel by agriculture is approximately three billion gallons per year. At 15 cents per gallon, the annual diesel tax collection would amount to approximately $420 million. This is a substantial increase in up-front cost of production. Individual producers may be forced to increase their operating loans to cover taxes ranging from several hundred to several thousand dollars depending on the farm's diesel fuel requirements. This will, in turn, increase the amount of interest producers will be required to pay to their lending institution. Even if some farmers and ranchers are not required to increase their operating loans, they will still lose the time value of their money.

There are problems and inequities that exist with regard to the refund system. In general, farmers may file for quarterly refunds of the tax if the refund for the quarter totals $1,000. Undoubtedly, there are some users who cannot qualify for quarterly refunds because the refund would be less than $1,000. In fact, it appears that less than 20,000 farmers will be eligible for quarterly refunds. Those farmers who would not qualify for quarterly refunds would be forced to loan money to the government until tax time when the diesel fuel tax would be filed as a tax credit against any tax liability owed to the IRS.

In addition to the added paperwork costs to farmers, the costs to the Internal Revenue Service of distributing and maintaining a refund system will subtract from the benefits of any added revenue which may find its way to the Treasury. Moreover, since interest payments are a deductible business expense, as interest costs rise, revenues for income tax to the Treasury will decrease. However, we understand that repeal of the provisions has a revenue cost. The Grange recommends that to offset the cost (1) the remittance of the collected tax be required on a weekly basis, (2) the fuel tax for private exemption buses, except school buses, be repealed, and (3) the wine tax credit be modified.

Taxation of Conservation Reserve Program Payments

The Internal Revenue Service has made a misinterpretation of the Congressional intent for self-employment taxation on rental payments. In the Food Security Act of 1985, Congress established a ten-year acreage set-aside program, the Conservation Reserve Program (CRP), to conserve our nation's vital resource - soil. In return for discontinuing production on highly erodible land, the Secretary of Agriculture reached agreements on the level of rental payments to be paid to producers by the Department of Agriculture.

In 1987, the Internal Revenue Service determined that payments made under the Conservation Reserve Program would be considered earned income for self-employment tax purposes. (According to the IRS, the CRP is similar to the Soil Bank Program, Revenue Ruling 60-32, 1960-1, C.B. 23 and the Crop Adjustment Program, Revenue Ruling 65-149, 1965-1, C.B. 434 and Revenue Ruling 68-44, 1968-1, C.B. 191.) This conclusion conflicts with the Congressional intent in the 1985 Farm Bill, treats payments from land leased to the government under the CRP program differently from payments for land leased to other renters, and discourages farmers from participating in the CRP.

As self-employed workers, farmers are required to contribute to the social security system under the terms of the Self-Employment Contributions Act [SECA]. Section 1402(a) of the Internal Revenue Code defines net earnings from self-employment for SECA tax purposes and stipulates that agricultural rental payments are excluded from net earnings if the renter does not "materially participate" in production on the land. Therefore, for a farmer who rents his property to another farmer and has no involvement in the production of the land, the rental payments are not considered earned income for SECA purposes. The IRS has determined for a farmer who participates in the CRP and is clearly not involved in production on the land, the rental payments he receives from the Secretary are treated as earned income.

To ensure that there would be no misunderstanding about the CRP payments, the farm bill conferees included language in the Conference Report that clarified the definition of a rental payment. The farm bill conferees concurred that:

> ". . . 'rental payment' mean(s) a payment made by the Secretary to an owner or operator of a farm or ranch containing eligible highly erodible cropland to compensate the owner or operator for retiring such land from crop production and placing such land in the Conservation Acreage Reserve."

The Conference Report also defined conservation payment as reimbursement for the cost of cultivating ground cover or grasses to replace the crop that had been grown on the land. However, the CRP payment is specifically and repetitively referred to as a rental payment from the Secretary to the farmer because the Secretary and the farmer entered a contractual agreement in which the farmer agreed to rent his highly erodible land to the Secretary in exchange for annual rental payments.

According to the Department of Agriculture, more than 160,000 farmers signed agreements with the Secretary to set aside highly erodible acreage for ten years. More than 8.2 million acres were taken out of production in 1987. The estimated annual rental payments exceeded $915 million with an average per farmer rental payment of $5,700 (resulting in an average per farmer tax increase of $742). And while taxing these payments would increase revenues for the social security system, such a levy would be unfair to farm households and would have an adverse effect on the CRP initiative.

Clearly, the IRS ruling is inconsistent with the Congressional intent. A number of steps have been taken to correct this problem; however, none have been successful to this point. We recommend that a provision be included in any technical tax correction legislation which forces the IRS to comply with the Congressional intent. The provision could say:

> "Rental payments made under the Conservation Reserve Program by the Secretary of Agriculture are not taxable under the terms of the Self-Employment Contributions Act."

Thank you for this opportunity to share our concerns with current tax policy. The Grange truly hopes these changes to S. 2238 (H.R. 4333) will be acceptable to you and the entire Finance Committee.

STATEMENT OF
NEW ENGLAND ELECTRIC SYSTEM

BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Comments on H.R. 4333,
the Technical Corrections Act of 1988

New England Electric System, a public utility holding company whose subsidiaries serve 1.2 million electric customers in the States of Massachusetts, New Hampshire and Rhode Island, is pleased to comment on H.R. 4333, the Technical Corrections Act of 1988. Our comments address the reduction in the dividends received deduction for portfolio stock investments.

Current law provides for an 80-percent intercorporate dividends received deduction if the stockholding corporation owns at least 20 percent of the stock of the dividend paying corporation. If less than 20 percent is owned, a 70-percent dividends received deduction is available. The purpose of the dividends received deduction is to eliminate, to a great extent, the multiple taxation of earnings at the corporate level.

The House Committee on Ways and Means has included a provision in the Technical Corrections Act that would phase down, over a three-year period, the dividends received deduction for "portfolio stock" from the present 80 percent or 70 percent levels to 50 percent. This proposed reduction, particularly when coupled with the reductions in the deduction percentage from 85 percent to present levels enacted in 1986 and 1987, is substantial and can have a significant negative impact on the New England Electric System and on other electric utilities operating in the New England region.

In the case of the New England Electric System companies, the dividends received deduction attributable to the single asset corporation dividends is used to lower electric rates for its customers. Thus, enactment of the House proposal will directly and adversely affect our customers' electricity bills.

According to the House Committee bill, ownership of 20 percent or less of the stock of a corporation is considered a "portfolio" investment and, thus, would be subject to the reduced dividends received deduction. The House Committee bill retains the higher dividends received deduction where ownership is greater than 20%, since the owning corporation is considered the "alter ego" of the distributing corporation.

Since the late 1950's, many electric utilities in New England have joined together to construct a number of large power generating facilities for the benefit of customers throughout the region. In certain instances, this joining together has been accomplished by formation of "single asset corporations" that are owned exclusively by New England-based electric utilities. Each single asset corporation owns and operates a specific power plant and sells the electricity produced from the plant to its stockholding utilities, generally, in direct proportion to their stock interests. The utility shareholders, in turn, resell the electricity at cost to their customers. Although the utility shareholder companies are truly "alter egos" of the single asset corporations, most would fail to qualify as such under the House Ways and Means Committee bill. Consequently, since most of the after-tax profits earned by the single asset corporations are regularly distributed as taxable dividends to the utility shareholder corporations, these earnings would be unfairly subject to double taxation at the corporate level. Furthermore, the earnings from these corporations would be taxed a third time when distributed as dividends to the owning utilities' individual shareholders.

The single asset corporation structures utilized by the utilities in New England to jointly share in large power projects clearly should not be construed as "portfolio investments". We urge the Senate Finance Committee to modify the dividends received deduction provision in the House bill to exclude classification of jointly owned utility power projects by utility corporations as portfolio stock investments.

We appreciate the opportunity to provide comments on this important tax matter.

Respectfully submitted,

Samuel Huntington

July 15, 1988

President and Chief Executive Officer,
New England Electric System

STATEMENT OF EDWARD I. KOCH
MAYOR
THE CITY OF NEW YORK
TO
THE SENATE COMMITTEE ON FINANCE
CONCERNING H.R. 4333, THE TECHNICAL CORRECTIONS ACT OF 1988
AS REPORTED BY THE HOUSE COMMITTEE ON WAYS AND MEANS

JULY 18, 1988

This statement summarizes the position of the City of New York on the provisions contained in H.R. 4333, the Technical Corrections Act of 1988, as reported by the House Committee on Ways and Means. The City supports passage of H.R. 4333 with certain modifications. There are many areas in the tax law which require legislation this year. Consequently, I urge the Senate Finance Committee to report a technical corrections bill similar to the House bill and to include in it extensions of expiring provisions and certain policy adjustments and clarifications.

This statement is divided into four sections. The first covers provisions in the House bill which the City of New York opposes. The second covers provisions in the House bill which the City of New York specifically supports. The third covers provisions which the City supports, but which we believe should be modified. The fourth section covers provisions not in the House bill which the City of New York urges the Finance Committee to include in its bill.

In view of the limits on the length of statements to the Finance Committee, the description of the various provisions will necessarily be brief. If the Committee desires more information on the City's position on any issue, I encourage them to contact the City of New York's Washington office.

PROVISIONS IN THE HOUSE BILL WHICH THE CITY OF NEW YORK OPPOSES

1. Extension of Private, For-Profit Housing Bond Restrictions to Charities. The City urges the Finance Committee to reject the House provision which would impose on charitable organizations which build housing the rules which apply to private, for-profit developers of housing.

The rules devised to restrict for-profit developers are unnecessarily burdensome for charitable organizations which are building and rehabilitating housing. These rules will discourage their involvement in solving the housing problems of the country. The City of New York urges the Finance Committee to reject such restrictions on housing by charitable organizations.

2. Repeal of Ability to Make In-Service Distributions of $3500 or Less (Section 457). The City of New York urges the Finance Committee to delete Sec. 111(e)(9) from the Technical Corrections Act of 1988, S. 2230 as introduced. That provision would eliminate the ability of participants in Eligible Section 457 Plans to receive small distributions that close out their participation in the plan while they still work for the state or local government.

This change is directly contrary to the intent of the 1986 Act and should not be considered a technical correction. The provision would also lose revenue. As introduced, the provision would also tax existing plans and participants who relied on the Tax Reform Act of 1986.

The Tax Reform Act of 1986 provided that distributions could be made from an Eligible Section 457 Plan as long as (1) the balance was less than $3500 and (2) the employee could no longer participate in the plan. This current law provision applies to distributions occurring both while the employee is still working for the state or local government and after the employee has separated from service.

Current law serves two functions. First, it makes it easier for lower paid employees to participate because they can be assured that if the salary reduction arrangement proves too burdensome, then they can not only stop having amounts withheld from their checks but can get back the funds already withheld. Second, it allows plan administrators to clear small accounts off of the books; accounts which otherwise would have to be carried for years until the person separates from service or retires.

The requirement in current law that if the employee elects this option, then he or she can no longer participate in the plan adequately protects against this option turning the Eligible Section 457 Plan into a tax-free savings account.

This provision loses revenue because it delays the receipt of income. When the lump sum is received, the employee pays tax on it. This provision delays receipt of the income until after separation from service rather than allowing an earlier, in-service distribution.

Finally, this provision in S. 2230 has a retroactive effective date of January 1, 1987. In reliance on the 1986 Act, the City of New York amended its Eligible Section 457 Plan to allow in-service distributions of less than $3500 effective January 1, 1987 and has in fact made such distributions. The retroactive effective date would make the City's plan taxable retroactively.

PROVISIONS IN THE HOUSE BILL SUPPORTED BY THE CITY OF NEW YORK

1. Extension of the Low Income Housing Tax Credit. The City of New York urges the Finance Committee to extend the Low Income Housing Tax Credit at least until December 31, 1990. The City also urges that the limited carryforward rule for 1989 be retained, or that some other provision be made for projects which have relied on that rule and which, under the House bill, are at risk of not having credits available to them.

There are many aspects of the Low Income Housing Tax Credit which the City believes should be modified, some of those are discussed in the next section; however, we also believe it is necessary to extend the program this year in this tax bill.

It takes at least 18 to 24 months from planning a low income housing project to placing it in service. Because the current sunset date is December 31, 1989, we are already at the time when the inception of new projects will be delayed. In order to prevent serious disruption in the program, it must be extended this year.

The Low Income Housing Tax Credit is an essential element in the City's housing program, a program which is unprecedented in this country. Within the next ten years the City will spend over $5 billion of its own funds to rehabilitate over 100,000 units of housing which have been abandoned or come into the City's hands through tax foreclosure. Those units will be made available to low income and homeless families. Some of the units will be operated by the City, but most will be turned over at no charge to community organizations or sold at low cost to developers. In addition to the equity raised through the syndication of the low income housing credit, the City will provide approximately $50,000 per unit to rehabilitate the units.

There is a dire need for low income housing in New York and throughout the nation. Such housing cannot be built without the combination of governmental subsidies and favorable federal income tax treatment. The housing problem is serious. The vacancy rate for low income housing in New York City is less than 1%. The waiting list for public housing in New York City is over 200,000 families. Because of the shortage of low income housing, the City is forced to house some homeless families in commercial hotels on an emergency basis. The City has worked hard and reduced the numbers housed in hotels, but still thousands of unfortunate families have no other place to live.

2. Exempt Bona Fide Debt Service Funds from Arbitrage Rebate. The City urges the Finance Committee to exempt the earnings on certain types of accounts called "bona fide debt service funds" from the arbitrage rebate requirement when those accounts are established for fixed rate governmental bonds with an average maturity of 5 years or longer. A similar provision was included in last year's Finance Committee's miscellaneous title.

The exemption of these accounts will ease considerably the administrative burden imposed on the City by the arbitrage rebate requirement. At the same time, it will not interfere with the policy behind arbitrage rebate. The policy is to remove any incentive to issue bonds in order to earn arbitrage.

Because of the way the financial markets work, it is virtually impossible to earn positive arbitrage which will be rebated on these accounts. Exempting them will not cost any revenue, nor will it encourage the issuance of arbitrage bonds, because there is no rebateable positive arbitrage to be earned. Existing Treasury regulations define a bona fide debt service fund.

3. Exempt State and Local Governments from Pension Distributions Beginning at Age 70 1/2. The City of New York urges the Finance Committee to exempt state and local governments from the requirement that pension distributions begin no later than when an employee reaches age 70 1/2, whether or not the employee has retired. This provision was included in last year's Finance Committee's miscellaneous title.

By the end of this year the City of New York will have 864 employees over 70 1/2 in the New York City Employees Retirement System (NYCERS) and 405 teachers over 70 1/2.

New York State law prohibits "double dipping," the payment of pension benefits to an employee who is still working for the City. The City must obey the state law and not pay the benefits. Failure to pay the pension subjects the employee to a tax of 50% of the unpaid benefit. Further, the Age Discrimination in Employment Act (ADEA) prohibits the City from setting a mandatory retirement age. The result is a series of conflicting, irreconcilable requirements on the City.

4. Exempt Authors and Artists from the Uniform Capitalization Rules. The City of New York urges the Finance Committee to exclude authors and artists from the uniform capitalization rules imposed under the 1986 Act. A similar provision was included in last year's Finance Committee's miscellaneous title.

The City believes that further relief is needed despite the recent IRS Notice 88-62 which laid out a three year safe harbor for authors and artists. The notice does make a positive recognition that projections of income by the artists are not necessary. However, the notice would still require authors and artists to delay their deductions and in effect to pay tax on half of their expenses. The application of the uniform capitalization rules to artists is extremely unfair, especially given the exemption for certain businesses with income up to $10 million a year.

5. Extension of Mortgage Revenue Bonds. The City supports the extension of the Mortgage Revenue Bond (MRB) program and especially supports the provision in the House bill which would adjust the family income eligibility levels in areas with relatively high housing costs and low median income.

Under the program's current eligibility structure, there is little or no program in New York City. The reason is that the combination of high housing costs with the City's relatively low median income means that if a family has income low enough to qualify for the program, they cannot afford to buy a house.

PROVISIONS IN THE HOUSE BILL WHICH THE CITY OF NEW YORK BELIEVES SHOULD BE MODIFIED

1. Low Income Housing Tax Credit. The City of New York urges the Finance Committee to include the package, contained in last year's House and Senate bills, of additional technical corrections and miscellaneous provisions designed to improve the usefulness and administrability of the Low Income Housing Tax Credit.

As noted above under the section dealing with the extension of the Low Income Housing Tax Credit, the City urges the Committee to include in any extension, a provision which preserves the current law limited carryover provision for 1989 credit. Many projects in New York have been operating under a schedule which relies on the availability of that carryforward provision. They should not now be paenalized for that reliance.

There are two additional provisions which deserve special mention. First, last year's House bill would have allowed a general, project specific, one year carryforward of the credit. Some provision to allow a carryforward is necessary for the orderly administration of the program and for the program to be used to its full potential.

Second, another important provision would prevent a decrease in the applicable income limits or permissible rents where there is a decrease in family size due to death, divorce, separation, or abandonment. This provision was included in H.R. 4333 as reported by the House Ways and Means Committee.

2. Apply Section 415 Limits to State and Local Plans Prospectively Only. The City of New York urges the Finance Committee to apply the Section 415 limits to state and local qualified plans only with regard to newly hired employees and allow time for state legislative action. A similar provision was included in last year's Finance Committee's miscellaneous title.

The provision as adopted by the House Ways and Means Committee does not allow enough time for state legislative action. The Ways and Means provision would require action by December 31, 1988. By the time this bill is enacted, the New York State legislature will have adjourned for the year. The time for action should be advanced to December 31, 1989.

The formulae in New York City's pension plans exceed the current Section 415 limits on maximum pension benefits which may be paid. The City cannot amend its plan to reduce the formulae for current employees because such a reduction would violate the New York State Constitution. This situation means that the City's pension plans are technically not qualified and, given the state constitutional constraints, could not be qualified plans.

Further, the City has, in fact, no power at all to amend its plan or make elections. All changes and elections must be authorized by the state legislature. Therefore, the date of application of the new limits must be far enough in the future to allow action by the New York State legislature and should not require the City to make elections.

3. Eligible Deferred Compensation Plans (Sec. 457) - Taxation of Nonretirement Benefits. The City of New York urges the Finance Committee to assure that accrued vacation, sick, compensatory time, severance, disability, and death benefits provided pursuant to state or local laws, rules, and regulations or pursuant to a collective bargaining agreement are not taxed under Section 457.

The City believes that the House bill does not adequately protect state and local government employees because it allows the Treasury Department to define "bona fide" and contains no safe harbor. Given the history of Treasury's positions on this issue, the City believes the Congress should adopt the language contained in S. 2480, introduced by Sen. Moynihan.

The City definitely opposes attempts to define "bona fide" by reference to "highly compensated employees" or a cap on the amount of benefits which public employees can accrue. The definition of highly compensated employees contained in the Code is extraordinarily complex and would involve applying the tests each year to at least 225,000 City employees and their various benefit packages. The application of a cap, contained in the report language accompanying the Finance Committee bill last year, is unfair, discriminatory, and an unnecessary intrusion of the federal government into municipal labor relations.

4. Extension of the Targeted Jobs Tax Credit. The City of New York urges the Finance Committee to extend the Targeted Jobs Tax Credit (TJTC) for two years without any changes to the program.

The House bill would eliminate eligibility for economically disadvantaged youth 22, 23, and 24 years old. In New York City, that age group accounted for one-third of the TJTC participants.

In 1987, 23,000 New York City residents including 4,500 public assistance recipients were employed in full time and summer jobs through the TJTC. 21,000 of those were youths in full time, year round employment. Though much needs to be done, TJTC has been effective in bringing out-of-school, out-of-work youth into the workforce.

5. Diesel Fuel Taxes. The City of New York urges the Finance Committee to revise its provision concerning diesel fuel recordkeeping to exempt state and local governments from the registration, bonding, and reporting requirements. Otherwise the Committee's legislation may require the use of logbooks, similar to the burdensome auto recordkeeping requirements of a few years ago.

At the least, the Committee should revise its provision to explicitly allow the Treasury Department the discretion to waive the registration, bonding, and reporting requirements for the over 82,000 state and local governments.

If the reporting requirements are imposed on state and local governments, the result will be a tremendous amount of unnecessary paperwork. The fuel usage of the fleets of garbage trucks, highway trucks, snow plows, and other vehicles will have to be recorded and reported. The City of New York has approximately 6,000 diesel fueled vehicles and purchases approximately 13.3 million gallons of diesel fuel each year.

The City of New York supports the efforts of both the Finance and Ways and Means Committees to allow exempt and off-the-road users of diesel fuel (such as tugboat operators) to purchase the fuel free of tax. However, both committees have done so in a way that imposes unnecessary recordkeeping burdens on state and local governments which the Treasury Department does not require under current law. Treasury Department Notice 88-30 exempts state and local governments from the reporting, registration, and bonding requirements under the diesel fuel provision contained in the Revenue Act of 1987.

Another problem involves the different treatment of diesel fuel and diesel for heating oil. Diesel heating oil is not subject to the $0.151 per gallon tax or the reporting requirements. The City of New York purchases approximately 5.7 million gallons a year of diesel for heating. This diesel oil is bought from the same supplier and, with the decentralized ordering and distribution system employed by the City, the imposition of reporting requirements for diesel used for one purpose but not the other will compound the administrative difficulty.

PROVISIONS NOT IN THE HOUSE BILL WHICH THE CITY OF NEW YORK URGES THE FINANCE COMMITTEE TO INCLUDE IN ITS BILL

1. Eliminate the "Cliff" in the Mass Transit Fringe Benefit. The City of New York urges the Finance Committee to preserve the exclusion for mass transit passes and vouchers when the employer provides more than $15 a month.

Under current regulations, if an employer gives more than $15 a month in mass transit passes or vouchers, the entire amount, including the first $15, becomes taxable. The City urges the Finance Committee to eliminate this effect and provide that regardless of the total amount of the mass transit fringe benefit provided by the employer, the initial tax-free amount will remain excluded from income.

The City of New York also believes that expansion of this fringe benefit can be a major factor in reducing air pollution and traffic congestion caused by automobile commuting. The City supports increasing the tax-free amount to $60 a month, which will be a greater incentive for employees to commute by mass transit and which will help overcome the bias in the tax code in favor of automobile commuting.

2. Exclude Need-Based Government Benefits from Determination of Dependency. The City urges the Finance Committee to provide that need-based government assistance not be included in the determination of whether or not a taxpayer has dependents.

This change would benefit low income working families who now are not eligible for the earned income credit, dependent exemptions, and head of household status because they receive benefits under federal, state, or local programs such as food stamps, medicaid, AFDC, and general assistance.

Under current law, a person only has dependents if he or she provides more than half of their support. When determining support, benefits provided through need-based government programs are considered support provided by someone other than the parent or guardian. This results in the determination that some working poor families have no dependents. They are therefore ineligible under current law for the earned income credit, dependent exemption, and favorable head of household status. This effect is counter to the policies of removing the poor from the tax rolls and encouraging them to be self-supporting.

3. Modify Tax-Exempt Bond Rules for Subacute Care AIDS Facilities. The City urges the Finance Committee to modify certain tax-exempt bond provisions to make it less expensive, faster, and allow greater flexibility to issue qualified 501(c)(3) bonds for subacute care AIDS facilities.

It is inappropriate and needlessly expensive for AIDS patients who need long term care, or who simply need shelter, to be treated in hospitals; currently there is no alternative. The need to provide facilities for the long term care of people with AIDS will increase dramatically over the next few years. As of April 1988, 14,294 people in the City had been diagnosed as having AIDS with an additional 100,000 New Yorkers suffering from HIV-related illnesses. It has been estimated that 400,000 people in New York have been infected with the AIDS virus. The City currently has 40 beds in the public hospitals devoted to long term care of AIDS patients, this year that number will increase to 110 beds.

The City's public hospitals have 36% of the AIDS patients, though they only have 16% of the hospital beds. More must be done to encourage the nonprofit hospitals to care for AIDS patients. Relieving teaching hospitals and hospitals affiliated with religious institutions from the $150 million per institution cap for subacute care AIDS facilities and easing the restrictions on pooled financings would allow facilities to be built faster, less expensively, and more flexibly.

The City plans to provide $25 million in capital funds for health related facilities for the long term care of AIDS patients. In addition, we provide shelter for 290 people with AIDS, and we will be increasing that number.

4. Exempt Trans-shipments of Imports and Exports from Double Application of the Harbor Tax. The City urges the Finance Committee to include in its bill a provision to exempt from a double application of the 4/10 of 1% harbor tax those imports and exports which pass through a U.S. port and are unloaded and loaded again for further waterborne transportation.

The Port Revenue Act of 1986 imposed a 4/10 of 1% harbor tax on the value of cargo loaded and unloaded at U.S. ports. Under normal shipping patterns, uninfluenced by tax-induced distortions, certain ports serve as gateways for imports and exports. Goods arrive at these ports, are unloaded, and loaded again to continue their journey. These goods, however, are subject to the harbor tax twice - once on unloading and again on loading. This creates an unfair burden and induces importers and exporters to adopt an inefficient method of business in order to minimize their taxes.

5. Exempt from Payment of Alcohol Excise Tax Transfers from a Foreign Trade Zone to a Customs Warehouse. The City of New York urges the Finance Committee to exempt from payment of the alcohol excise tax transfers from a foreign trade zone to a customs warehouse and not to place a cap on the amount eligible for such an exemption.

The Tax Reform Act of 1986 imposed a new system for the collection of alcohol excise taxes which will result in the export of American jobs. The Act imposed tax on the first removal from a foreign trade zone or customs bonded warehouse, rather than the last removal.

Distilled spirits importers do more than warehouse and deliver imported goods. They also bottle bulk goods and repackage shipments. The effect of the 1986 changes is to make it advantageous for importers to ship their goods to Canada or Mexico to perform those operations, and then to ship into the United States. After the 1986 Act the importers can delay payment of the tax by one step in the shipping process if they remove their operations from the United States.

Last year, a provision in the House bill would have imposed a cap on the quantity which could qualify for the single tax-free transfer. All that such a limit would do is to delay the day that the importers would leave the United States. Once the limit is reached, the tax law would again give the importers the incentive to leave the United States.

WHEN DELIVERY MUST BE ASSURED.....

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July 19, 1988

Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen, Senate Office Building
Washington, DC 20510

Re: Senate Finance Committee Hearing on Section 89

Dear Ms. Wilcox:

The comments outlined in this letter are for the record of the hearing on Technical Corrections on July 13, 1988.

As an employer with a non-contributory comprehensive welfare benefit plan, we are now faced with the onerous task of proving that our plan is non-discriminatory.

We have always sought to maintain equal levels of benefits for all full-time employees regardless of location. We do, however offer benefits to part-time employees on a partial contributory basis. Consequently for our total employee population working more than 17.5 hours per week, we have a plan that will likely be discriminatory. The different contribution level for part-time employees and dependents has added two more plans. We will have to look into the possibility of aggregating plans and could be better off discontinuing the option for part-time employees to obtain benefits since the contribution arrangement for part-time is different from that for full-time employees.

Also, since employee-pay-all plans are not subject to testing, we may be forced to consider eliminating our contribution for dependent health care which is currently non-contributory.

If we finally determine we would like to leave our plans alone and let employees be taxed on the value of the benefits, the rules concerning what should constitute the value of the benefits are vague.

In summary, while the goal of non-discrimination may have some worth, we are appealing for more workable rules and less complicated tests, and fairer consideration for employers who have conscientiously strived to maintain a non-discriminatory plan.

Sincerely,

Rudy B. Markmiller

Rudy B. Markmiller
President

encls. (4)

RBM/ns

NORTH TILLAMOOK COUNTY HOSPITAL DISTRICT

dba: H.E. RINEHART MEMORIAL HOSPITAL
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Phone: (503) 368-5119

July 20, 1988

U.S. Senate Committee on Finance
SD-205, Dirksen SEnate Office Building
Washington, D.C. 20510

RE: Comments for the Record - July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverge test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional helath plan and a Health Maintenance Organization--as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatiory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex--yet, as the effective date draws nearer, we are still lacking necessary Treasury regulation. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules wll be effective.

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated," but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards--you should consider the following alternatives:

1. Repealing Section 89;
2. Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
3. Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Ken Cafferty
KEN J. CAFFERTY
Administrator

KJC/cm

"EQUAL OPPORTUNITY EMPLOYER"

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OREGON SAW CHAIN DIVISION

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July 20, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely

Kim Kaphammer

Kim Kaphammer
Benefits Administrator

July 19, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
SH-203, Hart Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 will bury most employers in time consuming paperwork. Most of the data required is difficult to obtain and will not be used for any other purpose. It will also lead to large expenses--at a time when many employers are already finding the cost of health care too high.

The concept of non-discrimination is commendable, but the Section 89 rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

It is not fair to penalize employers who wish to provide employees with a choice among benefits. Assuming a plan is non-discriminatory, the cost of gathering data, as well as testing, is staggering.

The rules are extremely complex--yet, we still lack necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules take effect.

Please consider the following alternatives:

* Repealing Section 89;
* Delaying the effective date for at least a year after Treasury issues final regulations;
* Simplifying the rules by establishing several reasonable alternatives.

Sincerely,

John Sall, President
Oregon Association of Health Underwriters

bjs

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July 22, 1988

Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate
Washington, D.C.

Dear Senator Bentsen:

This letter is submitted for inclusion in the record of the hearings of the Committee on Finance with respect to S. 2238, the proposed Technical Corrections Act of 1988 (the "Act"). Section 112(bb)(1) of the Act would modify the foreign personal holding company ("FPHC") provisions of the Internal Revenue Code (the "Code") as they apply to the U.S. beneficiaries of a foreign trust that in turn owns stock of an FPHC. Specifically, it would provide for the issuance of regulations under which a proportionate share of amounts actually distributed by an FPHC to such a foreign trust would instead be deemed to have been distributed (and hence would be taxable) to the U.S. beneficiaries of the foreign trust.

For the reasons set forth below, section 112(bb)(1) of the Act should be amended to provide that, at least in cases where this new deemed distribution rule is applicable, subsequent actual distributions by the intervening foreign trust to its U.S. beneficiaries would first be treated as distributions of the income that was previously taxed to such beneficiaries under the amended FPHC provisions.

Present Law.

Under present law, the U.S. shareholders of an FPHC are taxed on their proportionate shares of the foreign corporation's undistributed FPHC income. In the Tax Reform Act of 1984, Congress added what is now section 551(f) of the Code to provide that stock of an FPHC that is owned by certain intervening entities (e.g., a foreign nongrantor trust) will be treated as owned proportionately by the U.S. owners of the intervening entity (e.g., the U.S. beneficiaries of the foreign trust). Under this so-called "hopscotch" rule, which was amended in certain respects by the Tax Reform Act of 1986, undistributed FPHC income in effect "skips over" the intervening foreign trust and is taxed to the U.S. beneficiaries of the trust. The hopscotch rule does not now apply, however, if the FPHC makes actual distributions to the foreign trust in an amount sufficient to eliminate what would otherwise be its undistributed FPHC income. In such a case, no U.S. tax is imposed on the U.S. beneficiaries by reason of such distributions to the foreign trust. A U.S. tax is paid by such beneficiaries when and as they receive distributions from the foreign trust.

Proposed Deemed Distribution Rule.

Section 112(bb)(1)(A)(ii) of the Act would amend section 551(f) of the Code so that in cases to which the hopscotch rule is applicable to treat the U.S. beneficiaries of a foreign trust as the U.S. shareholders of an FPHC, regulations are to be prescribed under which distributions by an FPHC to a foreign trust which owns stock of the FPHC would be deemed to have been made those U.S. beneficiaries who, under the hopscotch rule, are deemed to own the stock of the FPHC.*/ The stated purpose of this change, which would apply to taxable years of foreign corporations beginning after December 31, 1986, is to prevent distributions by an FPHC that produce no current U.S. tax (e.g., distributions to the foreign trust) from reducing undistributed FPHC income.

The Problem.

It is readily apparent that, when the deemed distribution rule is added to the FPHC provisions of present law, a U.S. beneficiary of an intervening foreign trust will always pay a current U.S. tax on his proportionate share of the FPHC income of the foreign corporation. If no portion of such income is distributed to the foreign trust, it will be taxed to the U.S. beneficiary as undistributed FPHC income, as under present law. If the entire amount of such income is distributed to the foreign trust, it will be taxed to the U.S. beneficiary under the new deemed distribution rule.

Under the Act, the application of the trust distribution rules would not be conformed to reflect the enactment of the deemed distribution rule. As a result, subsequent actual distributions by the trust of amounts not in excess of the prior deemed distributions (which would have been previously taxed) may in effect be taxed a second time. This is because the rules of the Code governing distributions by foreign trusts provide that such distributions will be deemed to include a proportionate share of the current year's income of the trust and a proportionate share of prior years' income of the trust. By reason of this failure to conform the trust distribution rules, the U.S. beneficiary will be worse off than if he owned the stock of the FPHC directly.

Proposed Amendment.

Section 112(bb)(1) of the Act should be amended to include in the revisions to section 551(f) of the Code a generic rule which provides that, in determining the character of distributions by a foreign trust to which the hopscotch rule applies, the first distributions received by the U.S. beneficiaries of such a trust will be deemed to be amounts that have been previously included in the income of the U.S. beneficiaries under the FPHC hopscotch provision (e.g., the deemed distribution rule).

Rationale for the Amendment.

The proposed amendment would simply assure that the U.S. beneficiary of an intervening foreign trust is placed is no worse position than if he owned the stock of the FPHC directly. This is the correct tax policy result. The original hopscotch rule and the deemed distribution rule are intended simply to assure that such a U.S. beneficiary could not gain a U.S. tax advantage by reason of the existence of the intervening foreign trust. However, in the absence of a conforming amendment with respect to the application of the trust distribution rules is made, the U.S. beneficiary will be faced with a tax disadvantage that he typically cannot avoid.*/

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*/ This would be accomplished by amending the last sentence of section 551(f) of the Code, which currently authorizes the issuance of regulations providing for certain adjustments to carry out the purposes of the hopscotch rule. As so amended, section 551(f) would also authorize regulations under which rules similar to those set forth in section 1297(b)(5) of the Code would be applicable in such cases. Section 1297(b)(5) is one of a series of provisions applicable to passive foreign investment companies and it would be amended by the Act to, among other things, impose the deemed distribution rule.

The proposed amendment is also consistent with other provisions of the Code and the Act aimed at preventing double taxation that might otherwise arise under various current inclusion rules. For example, as noted, the original FPHC hopscotch rule (section 551(f) of the Code) itself contemplated that the Treasury would issue regulations to prevent instances of double taxation. While the specific example in the legislative history of the 1984 Act deals with the application of the hopscotch rule when the intervening entity is a corporation, there is no suggestion in that legislative history that such regulations could not address the issue in the context of intervening trusts. Similarly, the current inclusion provisions of subpart F of the Code have always contained a "hopscotch" rule and have always contained a mechanism (now embodied in section 959 of the Code) aimed at preventing some forms of this type of double taxation. Indeed, in the Tax Reform Act of 1986, in connection with a major expansion of the subpart F provisions, Congress adopted a non-generic relief provision of precisely the type contemplated by the proposed amendment here. Finally, the proposed new FPHC deemed distribution rule itself contains (in proposed Code section 1297(b)(5)(B)) a limited no double taxation provision. In short, Congress has consistently accepted the notion that the current inclusion rules should be structured to prevent double taxation and the proposed amendment does no more than apply this well established principle to cases where the intervening entity is a foreign trust.

Notwithstanding the foregoing, it is understood that concern has heretofore been expressed that amendments of the type proposed here would require a significant alteration of the trust distribution rules that is in itself objectionable on tax policy grounds and, further, that such proposed amendments would inappropriately permit increased deferral of U.S. tax on other income of the intervening trust. Neither of these objections is a valid reason for rejecting the proposed amendment.

No direct alteration of the trust distribution rules is required. The proposed amendment would simply provide a threshold ordering rule under which trust distributions would be deemed to consist of previously taxed FPHC income before the regular trust distribution rules are applied. Moreover, this ordering rule parallels the subpart F ordering rule for corporate distributions (section 959(c) of the Code), under which corporate distributions first deemed to be out of previously taxed income and subsequent distributions are characterized under the regular corporate distribution rules. Thus, just as section 959(c) of the Code in effect sets up a nontaxable account receivable outside the regular corporate distribution system, and which Congress clearly intended to apply to the FPHC hopscotch rule in the case of intervening corporations, the proposed amendment (like the non-generic subpart F intervening trust rule adopted by Congress in 1986) would establish a similar account outside the regular trust distribution system for FPHC rules.

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*/ To a limited extent this problem exists under present law, but the proposed deemed distributed rule makes the policy justification, and the need, for the proposed amendment even more compelling.

There is no discernable tax policy reason why the trust distribution system should be viewed by Congress as more sacrosanct than the corporate distribution system. Once an entity is skipped over for inclusion purposes, it should be skipped over distribution for purposes. The kind of entity disregarded under the hopscotch rule should make no difference. Moreover, because there is no evidence that Congress intended that the relief regulations under the FPHC hopscotch rule should be inapplicable to intervening trust cases, the proposed amendment can properly be viewed as clarifying in nature.

Finally, it is no answer to suggest that the possible deferral of U.S. tax on other income of the trust warrants rejection of the proposed amendment. The very same possibility exists for controlled foreign corporations under subpart F. Moreover, if deferral is perceived to be the problem, it should be addressed directly (as Congress has done) and not indirectly through the rejection of an obviously necessary and appropriate ordering rule.

* * *

In connection with the foregoing, it should be noted that the FPHC provisions of the Act, when viewed from a broader perspective, appear to reflect a judgment that portions of the subsequently enacted passive foreign investment company ("PFIC") rules should be incorporated into the FPHC provisions. Congress should, at the appropriate time, give consideration to including in this selective incorporation policy the "look through" rules of section 1296(c) of the Code. These look through rules reflect the correct judgment that the status of a foreign corporation as a PFIC should be determined by reference to the assets and income of the corporations in which it holds a substantial interest. That same logic should be applied to the FPHC provisions at an early date.

Sincerely,

Donald V. Moorehead

Donald V. Moorehead

PAYLINE SYSTEMS, INC.
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July 20, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsors with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization--as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

* Repealing Section 89;

* Delaying Section 89's effective date to at least a year after Treasury issues final regulations;

* Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Janice M Richard

Janice M. Richard
Office Manager

PENSION
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918 16th Street, N.W. Suite 704 Washington, D.C. 20006 (202) 296-3776

July 24, 1988

The Honorable Lloyd Bentsen, Chairman
Committee on Finance
Room SD-205
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

We are writing in response to your June 30, 1988 request for written statements commenting on the Technical Corrections Act of 1988, H.R. 4333.

We have enclosed a copy of a letter we wrote to you a year ago expressing our views on Section 111(f) which would provide new rules for Simplified Employee Pensions. The letter stated our opposition to Section 111(f) on the ground that the proposed new rules are substantive rather than technical, and that they represent unsound tax and retirement policies.

Quite frankly, we do not understand why Section 111(f) has remained in the Technical Corrections Act. Certainly no one we have talked to at the staff level thinks that the proposed rules are appropriate for technical corrections legislation or that they make sense.

As the "father" of the SEP, you are aware that SEPs are the best chance that lower-income employees employed by small businesses have for pension coverage. SEPs offer their employers significant tax advantages and generous retirement benefits without any of the administrative burdens associated with traditional pension plans -- SEPs can be set up in a matter of minutes with an IRS form. Up until recently the trade off for this "easy" pension plan was that all contributions to a SEP were made by the employers.

Unfortunately for lower-income employees, the Tax Reform Act of 1986 permitted employers with 25 or fewer employees to set up SEPs that contained only voluntary employee contributions. These salary reduction SEPs were patterned after 401(k) plans used by larger companies. An important difference is that they are free of the reporting and disclosure requirements required of 401(k) plans to assure compliance with the law. These new do-it-yourself SEPs are, of course, of no value to lower-income employees who cannot afford to save voluntarily.

Section 111(f) would dramatically increase the number of employers able to set up salary reduction SEPs, rather than traditional employer-paid SEPs. Employers with more than 25 employees would be able to set up these savings plans (and make no employer contributions) as long as only 25 of their employees were eligible to participate in the SEPs. Larger employers with a great many young employees, or employees represented by a union, would qualify. This is plainly not what Congress intended in 1986, and it should not be permitted now. Section 111(f) would needlessly hurt lower-income small business employees, most of whom are women, without serving any public policy objective.

With the thought that it might be helpful in your deliberations, we have enclosed a copy of a booklet on SEPs that we recently wrote for the U.S. Department of Labor and the Small Business Administration.

Sincerely yours,

Karen W. Ferguson

Karen W. Ferguson
Director

Anne E. Moss

Anne E. Moss
Women's Pension Project Director

enc.

July 24, 1987

The Honorable Lloyd Bentsen, Chairman
Committee on Finance
205 Dirksen Office Building
Washington, D.C. 20510

Dear Chairman Bentsen:

We are writing to comment on Sections 111(f)(1)(a)(ii) and (2) and Section 111(f)(7)(2) of the proposed Technical Corrections Act of 1987 (S. 1350). These sections would eliminate important substantive protections that are now provided by the Tax Reform Act of 1986 to workers covered by Simplified Employee Pensions. They would significantly expand the number of companies able to offer salary reduction SEPs and would delay the effective date of the SEP integration rules. We oppose these changes. They are not "technical" and they represent unsound tax and retirement policies inconsistent with the pension equity objectives of the Tax Reform Act.

I. Section 1108(a) of the Tax Reform Act permits businesses with 25 or fewer employees to offer a salary deferral arrangement as part of a Simplified Employee Pension plan. Sections 111(f)(1)(a)(ii) and (2) of the Technical Corrections Act would make salary reduction SEPs available to companies with 25 employees who "are eligible to participate" in the SEP.

Employers are permitted to exclude the following categories of employees from SEPs:

- employees who have not worked for the company during 3 out of the last 5 years;
- employees who earn less than $300 a year;
- employees who have not reached age 21;

- employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining; and

- non-resident aliens.

The proposed change would, accordingly, permit businesses of any size to offer a salary deferral SEP as long as only 25 employees were eligible to participate. For example, an employer with 100 workers could offer a salary deferral SEP as long as 75 of the workers had fewer than three years of service or were represented by a union.

This was not what Congress intended in adopting Section 1108(a). Members of Congress heard testimony that only 14 percent of workers in companies with fewer than 25 employees are covered by retirement plans and that small businesses are often deterred by the high administrative costs of setting up 401(k) plans. The salary deferral provision included in the law was carefully targeted to provide a simplified tax deferred savings vehicle for these very small companies. There was no intention that it apply to larger employers that can easily afford a 401(k) plan as a trade-off for the very generous tax shelter that 401(k)s provide for themselves and their middle income and high-paid employees.

Permitting companies with more than 25 employees to offer salary reduction features in their SEPs would undercut the retirement security of workers who might otherwise benefit from these plans. The availability of a salary deferral feature encourages companies to set up SEPs funded entirely by voluntary savings rather than employer contributions. This means that lower-paid employees who cannot afford to save for themselves will receive no benefits from these plans. It also invites tax abuse since SEPs are free of the reporting obligations that permit the government to test for nondiscrimination (and have to cover only 50% rather than 70% of employees).

II. The Tax Reform Act limits the amount of social security that employers can take into account when contributing to SEPs. Starting in 1987, employers contributing to a SEP are required to make contributions for all eligible employees. No longer can they contribute only for employees earning more than $43,800, the social security wage base. Also under current law, the percentage of pay contributed on earnings over the wage base cannot be more than twice the percentage of pay contributed for earnings below the wage base.

The decision to make these new integration rules effective immediately for SEPs reflects the fact that SEP contributions are determined on a year-to-year basis. Unlike other plans where plan documents depend on a fixed formula or require the contribution of a set percentage of pay or profits, an employer maintaining a SEP chooses each year how much to contribute--or whether to contribute at all. There is no need to amend plan documents or revise pre-determined funding schedules to bring SEPs into compliance with the new integration rules.

The fact that the IRS has not issued regulations for the new SEP integration rules is no justification for denying lower-paid workers much needed benefits for an additional two years. The requirements of the law as applied to SEPs are straightfoward, and can easily be implemented in the absence of IRS interpretation. Should there be ambiguities, they can readily be resolved. Virtually all non-model SEPs are issued by financial institutions that can request IRS rulings to assure that their plans are in compliance with the new law.

The 1987 effective date for the new SEP integration rules reflects a deliberate policy change designed to afford important protections to the growing number of workers covered by SEPs. We trust you will not do away with those protections under the guise of technical corrections.

Sincerely yours,

Amy Shannon

Amy R. Shannon
SEP Campaign Coordinator

Price Waterhouse

July 20, 1988

The Honorable Lloyd Bentsen
Committee on Finance
205 Dirksen Building
Washington, D.C. 20510

Dear Mr. Chairman:

This letter responds to your June 30, 1988 announcement of a Senate Finance committee hearing on the Technical Corrections Act of 1988 which indicated that written statements for the record of the hearing could be submitted no later than July 25, 1988. We welcome this opportunity to submit the following comments for the record.

ALTERNATIVE MINIMUM TAX - IMPACT ON COMPANIES EMERGING FROM TROUBLED DEBT RESTRUCTURINGS

Companies that successfully emerge from troubled debt restructurings will satisfy their obligations with either cash, new debt, securities or some combination of the three. In general, most debtors will achieve in a nontaxable transaction, a reduction in debt through (1) an outright forgiveness, or (2) an exchange of debt for stock. These items are nontaxable to the extent of the company's insolvency.

In many cases, the creditor accepts an equity interest in the debtor in satisfaction of the debt where the value of the equity is less than the amount of the original debt. In general, this occurs because the creditor has concluded that such an agreement is necessary to maximize the recovery of its investment (i.e., the creditor's objective is to make the best of a bad situation) and the company is willing to give up substantial equity to creditors so that the company can survive.

In general, the accounting rules provide that to the extent that the debt extinguished exceeds the value of any stock issued, the excess, if material, is reflected as an extraordinary gain in the financial statements.

Although the income statement reflects the amount as an extraordinary gain, the financial statements taken as a whole clearly reflect a company that is struggling to emerge from or avoid falling into bankruptcy.

However, recording such gain in the financial statements may result in a significant additional tax liability to the company--even though the company may have otherwise experienced a loss during the year--in that the debt restructuring may cause the company to be subject to the alternative minimum tax (AMT).

Code section 56(f)(2)(a) states,

> In General - The term 'adjusted net book income' means the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement, adjusted as provided in this paragraph.

Unfortunately, no specific adjustment is provided to exclude this extraordinary gain from adjusted net book income.

In contrast, a company in Chapter 11 bankruptcy proceedings, using the stock-for-debt exception, might not report an extraordinary gain from the transaction for financial statement purposes if the quasi-reorganization provisions of Accounting Research Bulletin No. 43, Chapter 7, Section A are satisfied. If no financial statement income is recognized, there is no AMT with respect to the transaction.

We believe that this result was not intended by Congress and that a specific adjustment should be provided to clarify that extraordinary gain amounts from troubled debt restructurings shall be excluded from the computation of adjusted net book income.

Example

During 1987, X Corporation, in order to avoid filing for bankruptcy protection, recapitalizes by exchanging shares of its common stock for outstanding subordinated debentures. If the restructuring was done pursuant to

FAS 15[1], this tax-free reorganization results in an extraordinary gain required to be reported in the financial statements. Note that no cash is received by X Corporation in this transaction; it merely involves the exchange of one type of capital (Common Stock) for another (Subordinated Debt).

Even though X Corporation experienced (1) a book loss before recognition of this extraordinary item, as well as (2) a regular taxable loss, a substantial AMT liability will be generated -- solely due to this transaction -- because of the difference between book income (after extraordinary items) and taxable income.

Book (Loss) Before Extraordinary Items	$ (100)
Extraordinary Gain on Debt Restructuring	1,000
Book Income	$ 900
Taxable Income	(100)
Difference	1,000
Alternative Minimum Taxable Income	$ 400
Alternative Minimum Tax	80

Note that, had X Corporation issued common stock for cash, there would have been no book gain and, therefore, no AMT liability.

The General Explanation of the Tax Reform Act of 1986 (hereinafter referred to as the Blue Book) states, "Congress concluded that the minimum tax should serve one

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1/ As defined in Statement of Financial Accounting Standards No. 15 (FAS 15). A restructuring of debt constitutes a troubled debt restructuring for purposes of FAS 15, if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court.

FASB Technical Bulletin 81-6 clarifies the applicability of FAS 15 to debtors in bankruptcy situations. In general, FAS 15 does not apply to debtors who, in connection with bankruptcy proceedings, enter into troubled debt restructuring that result in a general restatement of the debtors liabilities.

overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits" (p. 432). Further, on page 434, the Blue Book states, "(I)n order to achieve both real and apparent fairness, Congress concluded that . . .whenever a company publicly reports significant earnings, that company will pay some tax for the year (emphasis added)."

To address the "apparent fairness" issue, Congress added the book income adjustment to the AMT calculation. The "economic income" issue is addressed via the adjustment for adjusted current earnings (ACE). Note that the ACE adjustment will replace the book income adjustment in 1990. Further, we believe that under current law, extraordinary gains from Chapter 11 proceedings or troubled debt restructurings will not be included in the ACE adjustment. Thus, the problem only exists as a result of the book income adjustment.

We believe this result to be extremely unfair. Although the income statement reflects the amount as an extraordinary gain included in net income, the financial statements taken as a whole clearly reflect a company that is struggling to avoid bankruptcy. Pursuant to FAS 15, the debtor must fully disclose the troubled debt restructuring, including a description of the principal terms and features of the settlement. Clearly, the new shareholders of the company, i.e., the former creditors, do not view the extraordinary gain as earnings. Rather, the acceptance of equity in exchange for outstanding debt was their only alternative short of forcing the company into bankruptcy. Neither a "real" nor anyone's definition of an "apparent fairness" would expect or require AMT to be imposed under these circumstances.

We believe that this unfair result was not envisioned by Congress. Congress enacted the book income adjustment in response to highly publicized instances in which companies reported significant earnings, but paid no tax. We believe that an extraordinary gain on a troubled debt restructuring does not constitute earnings as envisioned by Congress and, therefore, the statute should be clarified to specifically exclude the gain from the calculation of adjusted net book income for purposes of the book income adjustment.

Recommendation

To clarify that this result was not intended by Congress, a specific provision should be added as subparagraph (I) of Section 56(f)(2) of the Internal Revenue Code is as follows:

(I) TITLE 11 AND INSOLVENT DEBTORS-- Adjusted net book income shall be reduced by the amounts excluded from gross income under section 108(e)(10)(b) to the extent such amounts were included in adjusted net book income.

Further, to clarify this matter with respect to adjusted current earnings, a specific provision should be added as paragraph (7) of Section 56(g) of the Internal Revenue code as follows:

(7) TITLE 11 AND INSOLVENT DEBTORS-- Adjusted Current Earnings shall be reduced by the amounts excluded from gross income under section 108(e)(10)(B) to the extent such amounts were included in adjusted current earnings.

Sincerely,

Price Waterhouse

Price Waterhouse

the Principal Financial Group

Principal Mutual
Life Insurance Company

STATEMENT

TO: THE U.S. SENATE COMMITTEE ON FINANCE

RE: HEARING ON TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986

DATE: JULY 1988

Purpose

The Tax Reform Act of 1986 added a new Section 89 to the Federal Internal Revenue Code. Among other things, this Section 89 contains nondiscrimination tests that, beginning in 1989, are to apply to all group life and health plans. These tests are intended to discourage (via tax penalties) those plans that:

1. do not extend coverage to classes of employees traditionally considered part-time workers; and

2. do not provide nonhighly compensated employees with benefits that are relatively close in value to the benefits provided highly compensated employees.

The Principal Mutual Life Insurance Company has no objections to this intent. We are, however, convinced that the Section 89 tests, as presently structured, are too onerous and that their attendant rules of application are too complex--particularly for small employer group plans. Collectively, these tests and rules have much more potential for harm than for good.
This Statement and its two addendums outline our small employer concerns and suggest Section 89 modifications that we believe could well serve both the interests of employers and the intent of Section 89. Accordingly, we ask that this Statement and its addendums be entered into the written record of the Committee's hearing.

Background

The Principal Mutual Life Insurance Company is headquartered in Des Moines, Iowa. We are a major underwriter of life and health insurance for small employer groups located throughout the United States. Our current policyholders include over 60,000 employers with fewer than ten full-time employees each. The programs sponsored by these employers provide coverage to approximately 363,000 employees and their dependents. The typical health plan in force has these characteristics:

1. A single common schedule of benefits available to all employees (highly compensated and nonhighly compensated) and their dependents.

2. Eligibility limited to full-time employees and their dependents (full-time defined as 25 or more hours per week) who submit satisfactory evidence of insurability.

3. Employer/employee cost sharing - employers generally pay all or a part of employee premium - employees generally pay all or a part of their dependent's premium.

The Nondiscrimination Tests - An Overview

There are three primary tests under Section 89. Each group life and health plan must satisfy either an 80% participation test or both a 50/90% eligibility test and a 75% benefits test. Application of these tests is to be governed by a series of very complex and difficult-to-understand rules. Clarifying regulations are needed before the tests can be consistently and correctly applied.

The easiest to apply of the tests is the 80% participation test. This test was specifically intended by Congress to be a simple alternative for employers who have a single common schedule of benefits available to all employees (highly compensated and nonhighly compensated) and their dependents. Accordingly, it is appropriate for application to our typical small employer group plans.

The 80% participation test requires simply that at least 80% of each employer's nonhighly compensated employees (and their dependents) be enrolled for coverage. The base for this test, however, must include (1) employees who are part-time (as few as 17 1/2 hours per week), (2) employees and dependents who decline to enroll because they have similar coverage under another employer's plan, and (3) employees and dependents who are refused coverage under evidence of insurability requirements.

Concerns

The Section 89 nondiscrimination tests and rules as applied to small employer plans concern us in two respects:

1. In order to conduct the tests, employers will need to maintain detailed personnel records. These records must identify employees and dependents in a variety of categories (full-time or part-time, eligible or not eligible, insured or not insured, etc.). Few of our 50,000 small employer policyholders presently have data bases sufficient for such purposes.
2. the characteristics of our typical small employer plan make it very difficult to accept that such plans could be labeled discriminatory under any reasonable criteria. Nevertheless, the majority of our plans will fail the 80% participation test.

The first of these concerns is based on the many years of experience we have acquired in administering the plans of our small employer policyholders.

The second of these concerns is based on the fact that a significant number of small employer plans have difficulty qualifying under our normal 75% participation underwriting rule, even though our percentage requirement is five points lower and our base is much smaller than that required by the 80% test. The validity of this concern has been confirmed through a survey and sample testing of 100 of our small employer health plans.

Small Employer Survey

The details of our small employer survey and sample testing are provided in Addendum A of this Statement. The most significant of the facts disclosed by our survey are:

1. When employee and dependent health coverages were separated for testing purposes, 56% of the resulting employee only plans and 70% of the resulting dependent only plans failed the 80% participation test.

2. When employee and dependent health coverages were aggregated for testing purposes, 68% of the resulting combined employee/dependent plans failed the 80% participation test.

3. Failure to satisfy the 80% participation test is often beyond the power of a small employer policyholder to prevent or correct. For example:

    a. If an employer has from five to nine nonhighly compensated employees, nonenrollment of any two (for whatever reason - unacceptable evidence of insurability, coverage under another employer's plan, affordability, etc.) automatically disqualifies the plan.

    b. If an employer has less than five nonhighly compensated employees, nonenrollment of any one (for whatever reason - unacceptable evidence of insurability, coverage under another employer's plan, affordability, etc.) automatically disqualifies the plan.

4. When a small employer plan fails the 80% participation test because part-time employees (as few as 17 1/2 hours per week) are not eligible for coverage, the employer has four options:

    a. revise the plan's eligibility requirements and attempt to enroll enough part-time employees to satisfy the test; or

b. reduce the working hours of the part-time employees to less than 17 1/2 hours per week, thus removing those employees from the test base; or

c. leave the plan as is - compute and report the taxable income penalty amounts; or

d. terminate the plan.

Unless transitional relief can be obtained to permit an orderly, gradual phase-in of expanded eligibility (i.e., eligibility of part-time employees), the sudden and immediate impact of the cost required to cover these employees will drive many small employers to seriously consider options b., c. and d.--none of which will serve the policy objective of expanded coverage.

Suggested Actions

We believe it imperative that the concerns expressed above be addressed. In our view, relief is necessary if the Section 89 nondiscrimination requirements are to be applied in an orderly, consistent and fair manner. To that end, Addendum B of this Statement contains a series of suggested regulatory/legislative actions that we urge the Committee to consider.

We fully support the policy objective of extending coverage to a broader base of rank-and-file employees and will encourage our policyholders to comply with Section 89. However, unless the rules can be simplified so that small employers are able to understand, apply and pass the tests, a proliferation of discriminatory plans may result. In our view, expansion of coverage must recognize the characteristics of small employer plans and must employ a measured, incremental approach in order to be successful.

Final Comment

We have limited the scope of this Statement to the particular problems posed by Section 89 for small employer groups. We are also concerned with the equally difficult problems for large employers. The Principal Mutual Life Insurance Company, as an employer, maintains benefit plans with 10,000 participants. We are faced with the task of gathering information, valuation and record keeping to test some 800 separate plans under purposes of Section 89. The effort required to monitor compliance for purposes of the eligibility and benefit tests will be monumental, even if all applicable rules were themselves clear and comprehensible.

PCC
Airfoils,
Inc.

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Telephone number (216) 831-3590
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July 20, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization--as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex--yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards--you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective data to a least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

M. S. Howell
Director, Human Resources

Comments on Section 89

Mary E. Wims
Assistant Vice President Personnel
Providence Journal Company

I have been in the pension and employee benefit field for over ten (10) years and have never been more frustrated with a piece of legislation than I have been with Section 89.

My company offers virtually identical basic health coverage to all employees and yet the provisions of Section 89 will require several levels of "testing" due to HMO options and single vs. family coverage. At the very least, adopting a nondiscriminatory "facts and circumstances" standard should satisfy your objective without the tedious multiple hurdle formulas in Section 89. Due to the vagaries of experience rated plans, community rated plans, and geographic variance in health cost, my plans may or may not comply with Section 89 provisions even though they clearly comply with "nondiscriminatory" intent. To be sure, many resources will be used up testing and patching benefit plans to fit some Treasury articulated value standard - resources which will profit my employees not at all and which might prove a tax drain.

Please consider a general safe harbor exemption, an 80 percent coverage test with a provision for minor value differential and a deadline extension. Perhaps the wiser move would be repeal of Section 89 altogether.

A competitive American economy will require more options, more individualized programs, and more employee cost consciousness in order to flourish. In its current form, Section 89 suggests plain vanilla coverage or none at all.

Quinault Indian Nation
POST OFFICE BOX 189 · TAHOLAH, WASHINGTON 98587 · TELEPHONE (206) 276-8211

July 25, 1988

The Honorable Max Baucus
706 Hart Senate Office Building
Washington, DC 20510
ATTN: Tim Vettel

Dear Senator Baucus:

I submit this letter and the enclosed Interior Department Solicitor Coldiron's September 1983 Opinion for inclusion in the July 12, 1988 hearing record on H.R. 2792 "Indian Fishing Rights Clarification" bill before the Senate Finance Committee's Subcommittee on Taxation and Debt Management hearing on "Miscellaneous Tax Bills."

Our principle concern is with Section (1)(c)(3) of the bill and the corresponding House report language. The section as presently drafted implies that any rights which presently exist under treaties and other federal law to an exemption from the taxation of income derived from the exercise of Indian fishing rights are abrogated, and replaced by the statutory exemption established by the bill. This is inappropriate and unnecessary. It establishes as dangerous precedent for the abrogation of treaty rights.

The IRS makes mockery of established Indian law and our treaty provisions with the contention that Federal income tax exemption language should have been included in our treaties. Our Treaty of Quinault was negotiated in 1856. The Sixteenth amendment to the Constitution allowing Federal taxation wasn't passed until 1913! Two separate Interior Department Solicitor Opinions (Coldiron 1983 and Richardson 1985) clearly support the Tribal position on this issue. I have enclosed Solicitor Coldiron's opinion on this issue for your review.

We reserved the right to fish in our "usual and accustomed" fishing grounds in our treaties. These fishing rights are a treaty-protected right upheld seven times in this century by the Supreme Court. Each Tribe in the Pacific Northwest manages their respective fishing licenses, their enrolled members, and enforces Tribal fishing regulations.

I appeal to you to assist in securing swift, decisive action and a favorable report on H.R. 2792 in these waning days of the 100th Congress. Two hundred years ago the U.S. Constitution was adopted. Congress also passed in 1787 the Northwest Ordinance which included the following:

> "The utmost good faith shall always be observed towards the Indians; their lands and property shall never be taken from them without their consent; and in their property, rights and liberty, they never shall be invaded or disturbed ... but laws founded in justice and humanity shall from time to time, be made, for preventing wrong being done to them, and for preserving peace and friendship with them."

Even though the administration supports H.R. 2792 and the House has passed this bill, the IRS has withheld collection efforts "for a reasonable period of time," and Indian fishermen continue to be brought before the U.S. Tax Court!

Your support and Senate Finance Committee action on H.R. 2792 "to clarify Indian treaties, Executive orders, and Acts of Congress with respect to Indian fishing rights" is critical.

Sincerely,

Joe DeLaCruz

Joe DeLaCruz
President
Quinault Indian Nation

United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

September 21, 1983

Memorandum

To: Assistant Secretary--Indian Affairs

From: Solicitor William H. Coldiron

Subject: Federal income taxation of Stevens treaty fishing income

You have asked my opinion as to whether the income of members of certain Washington State treaty tribes generated from commercial fishing pursuant to the treaties is subject to the federal income tax. It is my opinion that fishermen who are members of tribes that have established treaty rights 1/ are exempt from federal income tax on fishing income earned pursuant to those treaties. This opinion does not apply to income earned by these same fishermen from other sources, such as fishing in nontreaty areas or to income derived from fish in excess of 50% of the available take. This opinion applies only to the federal income tax and does not apply to any other federal tax, excise, fee or license of any kind whatsoever. This opinion does not apply to State taxation in any form.

Your request for my opinion was, I understand, prompted by recent enforcement efforts of the Internal Revenue Service directed toward members of the Lummi, Tulalip, Puyallup and Swinomish Tribes 2/ and seeking to collect taxes on treaty

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1/ United States v. Washington 384 F.Supp. 312 (W.D. Wash. 1974), aff'd 520 F.2d 676 (9th Cir. 1975) cert. denied, 423 U.S. 1086 (1976); United States v. Washington, 459 F.Supp. 1020 (W.D. Wash. 1978); Puget Sound Gillnetters Ass'n v. U.S. District Court, 573 F.2d 1123 (9th Cir. 1978); Washington v. Wash. State Commercial Passenger Fishing Vessel Ass'n, 443 U.S. 658 (1979).

2/ In addition to these tribes, other tribes with treaty rights in Washington include the Hoh, Makah, Muckleshoot, Nisqually, Quileute, Quinault, Sauk-Suiattle, Skokomish, Squaxin Island, Stillaguamish, Upper Skagit, Nooksack, Suquamish, Port Gamble Band of Clallam Indians, Lower Elwha Tribal Community, Jamestown Band of Clallam Indians and the Yakima Indian Nation. A number of Oregon and Idaho Indian tribes have similar treaty fishing rights.

fishing income. The Internal Revenue Service, of course, has responsibility for the interpretation and enforcement of the federal income tax laws. However, this Department has the primary responsibility within the federal government for the protection of Indian treaty fishing rights, including the authority and responsibility to interpret those rights. Accordingly, I believe it is not only appropriate but necessary that I interpret the treaties in this instance, where the interpretation of the federal tax laws under which the IRS is proceeding may conflict with fishing rights guaranteed under the treaties.

At the outset, I recognize that the only two decided cases on this issue have found that treaty fishing income is subject to the federal income tax. Strom v. Commissioner, 6 T.C. 621 (1946), aff'd per curiam, 158 F.2d 520 (9th Cir. 1947); Earl v. Commissioner, 78 T.C. 1014 (1982). However, as more fully discussed below, both decisions suffer from a lack of adequate consideration of the treaty rights involved. The Strom case was decided prior to both the United States v. Washington series of cases, which comprehensively interpreted the treaty fishing rights for the first time, and the Supreme Court's decision in Squire v. Capoeman, 351 U.S 1 (1956), now the controlling case on questions of federal taxation of Indian trust and treaty income. The Earl case was brought pro se by an individual Indian fisherman, who never presented the court with the appropriate arguments on his own behalf. I do not believe therefore that these cases may be considered dispositive of the issue.

The Treaties

The treaties relevant to this issue are the six treaties negotiated by Governor Stevens in the 1850's with tribes in Washington State. 3/ Governor Stevens negotiated these treaties in order to clear title to the lands then in the Territory of Washington. The tribes and bands in Washington ceded title to vast areas of land in exchange for small reservations and various other guarantees. With immaterial variations, the treaties each provide:

> The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians, in common with all citizens of the United States; and of erecting temporary houses for the purpose of curing; . . .

Article 4, Treaty of Point No Point, 12 Stat. 933.

This reservation of a right to fish has been interpreted seven times by the United States Supreme Court. United States v. Winans, 198 U.S. 371 (1905); Seufert Bros. Co. v. United States, 249 U.S. 194 (1919); Tulee v. Washington, 315 U.S. 681 (1942); Puyallup Tribe v. Department of Game (Puyallup I), 391 U.S. 392 (1968); Department of Game v. Puyallup Tribe (Puyallup II),

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3/ Treaty of Medicine Creek, December 26, 1854, 10 Stat. 1132; Treaty of Point Elliott, January 22, 1855, 12 Stat. 927; Treaty of Point No Point, January 26, 1855, 12 Stat. 933; Treaty of Neah Bay, January 31, 1855, 12 Stat. 939; Treaty with the Yakimas, June 9, 1855, 12 Stat. 951; Treaty of Olympia, July 1, 1855 and January 25, 1856, 12 Stat. 971.

414 U.S. 44 (1973); Puyallup Tribe v. Department of Game (Puyallup III), 433 U.S. 165 (1977); Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel), 443 U.S. 658 (1979). These decisions establish the treaty right of the Indians to fish at their usual and accustomed places free of state regulation except where necessary for purposes of conservation and their right to take up to 50% of the available fish.

The fishing rights reserved by the Indians in the treaties included not only the right to fish for subsistence purposes but the right to fish for commercial purposes. At the time of the treaties, the Indians fished commercially, as recognized by the Supreme Court: "Fish constituted a major part of the Indian diet, was used for commercial purposes and indeed was traded in substantial volume." Fishing Vessel, supra, 443 U.S. at 665. Quoting from the district court's opinion, the Court described the Indians' reliance on fish for commercial purposes in more detail:

> "At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present-day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition to potlatching, which is a system of exchange between communities in a social context often typified by competitive gifting, there was a considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the area. Those involved in negotiating the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians' fish for them, plus clams and oysters."

443 U.S. at 665-666, n.7. The Court went on to find that, "During the [treaty] negotiations, the vital importance of the fish to the Indians was repeatedly emphasized by both sides, and [Governor Stevens'] promises that the treaties would protect that source of food and commerce was crucial in obtaining the Indians' assent." 443 U.S. at 676. The Supreme Court's conclusion that the treaty reserved to the Indians a right to take up to 50% of the available fish incorporates the Court's recognition of the role of fish in the Indians' economy and its recognition that the treaty negotiators understood that role and intended that the

right to fish commercially was to be included in the rights reserved to the Indians.

Other Supreme Court decisions have held that the State of Washington could not require an Indian exercising off-reservation fishing rights to purchase a state fishing license, Tulee v. Washington, supra, and that the state's regulatory authority over treaty fishing was limited to that regulation reasonable and necessary for conservation. Tulee, Puyallup I, Puyallup II.

The United States, a direct party to the treaties, is of course bound by them and, absent exercise by Congress of its power to abrogate treaties, is subject to limitations similar to those imposed on the state with regard to the Indians' treaty rights. United States v. Winans, supra, 198 U.S. at 381-382; Hoh Indian Tribe v. Baldridge, 522 F. Supp. 683 (W.D. Wash. 1981).

The Tax Cases

In Squire v. Capoeman, 351 U.S. 1 (1956), the leading case on federal taxation of Indian income, the Supreme Court considered whether capital gains from the sale of standing timber on allotted lands was subject to the federal income tax. The Court held that the General Allotment Act of 1887, 24 Stat. 388, created an exemption from the tax in the circumstances before it. In reaching its conclusion, the Court acknowledged that the General Allotment Act did not contain an express exemption from the tax but nonetheless inferred an exemption from the government's undertaking, expressed in section 5 of the act, 25 U.S.C. §348, to convey the allotment at the end of the trust period "free of all charge or incumbrance whatsoever" and a 1906 amendment to section 6 of the act, 25 U.S.C. §349, which provides for removal of "all restrictions as to . . . taxation" after issuance of a fee patent. 351 U.S. at 6-8. The Court also found that the tax exemption was necessary to fulfill the purpose of the allotment system "to protect the Indians' interest and 'to prepare the Indians to take their place as independent, qualified members of the modern body politic.'" 351 U.S. at 9.

The Court responded thus to the government's argument that the case should be treated as an ordinary tax case:

> We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens. We also agree that, to be valid, exemptions to tax laws should be clearly expressed. But we cannot agree that taxability of respondents in these circumstances is unaffected by the treaty, the trust patent or the Allotment Act.

351 U.S. at 6.

While the Court acknowledged that a tax exemption must be clearly expressed, it found the necessary clear expression in language which, as noted above, implied, rather than expressly stated, the exemption. 351 U.S. at 6-8. It did so by reference to the intent of Congress in the General Allotment Act, 351 U.S. at 7-8, and to the principle of treaty and statutory construction which the Court described thus:

> Doubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith. Hence, in the words of Chief Justice Marshall, "The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense." [Citations omitted]

351 U.S. at 6-7. 4/

The Court in Capoeman held that the taxes from which the General Allotment Act was intended to shield allotments during the trust period included the federal income tax, even though that tax was not in existence at the time the General Allotment Act and its 1906 amendment were enacted. 351 U.S. at 7-8. The Court also rejected the argument put forth by the government that taxation of income derived from an allotment was sufficiently distinct from direct taxation of the allotment to make income taxation permissible even if direct taxation were prohibited. See 351 U.S. at 6.

Lower court decisions following Capoeman have established that the tax exemption in the General Allotment Act applies as well to allotments made under other allotment acts even though those acts do not necessarily contain the exemptive language of the General Allotment Act. Big Eagle v. United States, 300 F.2d 765 (Ct.Cl. 1962); United States v. Hallam, 304 F.2d 620 (10th Cir. 1962); Stevens v. Comm'r, 452 F.2d 741 (9th Cir. 1971). The courts reasoned that the other

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4/ This same rule was called upon by the Supreme Court in Fishing Vessel when it discussed the necessity of interpreting the Stevens treaties in accord with the intent of the parties:

> [I]t is the intention of the parties, and not solely that of the superior side, that must control any attempt to interpret the treaties. When Indians are involved, this Court has long given special meaning to this rule. It has held that the United States, as the party with the presumptively superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. "[T]he treaty must therefore be construed, not according to the technical meaning of its words to learned lawyers, but in the sense in which they would naturally be understood by the Indians." This rule, in fact, has thrice been explicitly relied on by the Court in broadly interpreting these very treaties in the Indians' favor. [citations omitted]

443 U.S. at 675-676.

allotment acts had the same purpose as the General Allotment Act 5/ and therefore the same tax exemption should apply. These decisions recognize the essential Capoeman holding as founded upon the purpose of the General Allotment Act rather than upon the presence of specific language.

Other lower court decisions which have addressed the extent of the General Allotment Act exemption have held that income earned by an Indian from land purchased and placed in trust for him under §5 of the Indian Reorganization Act, 25 U.S.C. §465, shares the tax exemption, Stevens v. Comm'r, supra, but that income earned by an Indian from tribal or other Indians' trust land does not. Holt v. Comm'r, 364 F.2d 38 (8th Cir. 1966), cert. denied, 386 U.S. 931; Fry v. Comm'r, 557 F.2d 646 (9th Cir. 1977), cert. denied, 434 U.S. 1011; United States v. Anderson, 625 F.2d 910 (9th Cir. 1980), cert. denied, 450 U.S. 920. The courts in these latter cases viewed the purpose of the General Allotment Act as one to protect the allottees' property from encumbrance during the trust period, a purpose which would not be infringed by taxation of an Indian's income from other than his own trust property. Thus, while holding the income at issue taxable, these decisions recognized the relevance of the underlying purpose of a treaty or statute to the determination whether language contained therein expresses a tax exemption applicable to the particular circumstances at issue.

The courts in Holt, Fry, and Anderson, having found the General Allotment Act exemption inapplicable, were also unable to find any exemption in other statutes or treaties relevant to the income at issue. These decisions, as well as others, 6/ demonstrate that a tax exemption must derive from language in a treaty or statute and that an exemption may not be based on policy alone or on generalized references to treaties and statutes. E.g., Anderson, supra; LaFontaine v. Comm'r, 533 F.2d 382 (8th Cir. 1976). While holding the particular income at issue taxable, these courts have followed the basic teachings of Capoeman. As the Court of Appeals for the Ninth Circuit stated in Anderson, that court's most recent opportunity to consider the issue,

> The rule that ambiguous statutes and treaties are to be construed in favor of Indians applies to tax exemptions, . . . but this rule "comes into play only if such statute or treaty contains language which can reasonably be construed to confer income [tax] exemptions" . . .

5/ The Court of Claims stated in Big Eagle, "Parallel congressional purposes [between the General Allotment Act and the Osage Allotment Act] are apparent, but the basic purpose is the one alluded to in Capoeman and that is to protect the property so that it will adequately serve the needs of the ward and finally bring him to a state of competency and independence. This chance is encouraged, if not guaranteed, by tax exemption." 300 F.2d at 771-772.

6/ E.g., Comm'r v. Walker, 326 F.2d 261 (9th Cir. 1964) and Jourdain v. Comm'r, 617 F.2d 507 (8th Cir. 1980) cert. denied 449 U.S. 839, holding the salaries of tribal officials taxable.

> "The intent to exclude must be definitely expressed, where, as here, the general language of the Act laying the tax is broad enough to include the subject-matter." (citations omitted.)

625 F.2d at 913. Further, in response to Anderson's argument that the policy of the General Allotment Act was applicable to his income earned from land other than his own (to which the court found the GAA exemption did not extend), the court stated,

> Capoeman and every other Supreme Court and Ninth Circuit case have held that such policy arguments are fruitless in the absence of statutory or treaty language that arguably is an express tax exemption. Such policy arguments, however, might persuade courts to construe such arguable language, if any exists, actually to be an express tax exemption.

625 F.2d at 914, n. 6.

Analysis

Capoeman and its progeny make clear that a tax exemption must be based on treaty or statutory language, arguably creating an exemption, which is applicable to the income-producing activity at issue. Once such arguable language is identified, however, the policy or purpose of the treaty or statute may be called upon to determine whether the language does in fact create an exemption.

The language in the Stevens treaties expressly securing to the Indians the right of "taking fish at usual and accustomed grounds and stations" is such arguable language. First, it is directly applicable to the fishing activity at issue. Thus the instant situation is easily distinguishable from the taxpayers' unsuccessful attempts in Holt, Fry, and Anderson to apply the General Allotment Act tax exemption to income from land to which the General Allotment Act itself did not apply, and from attempts to infer tax exemptions from other statutory or treaty language which had no direct relation to the activity at issue. E.g., Anderson, Jourdain v. Comm'r; LaFontaine v. Comm'r. 7/

Second, the treaty provision states no limitation on the Indians' right to fish at usual and accustomed places other than that the right is to be exercised in common with citizens. On its face, the provision might well be read to prohibit any limitation on or diminishment of the fishing right other than the one specified. Of course, it might also be read

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7/ In Anderson, the Ninth Circuit rejected arguments that sections 5, 6, and 16 of the Indian Reorganization Act, 25 U.S.C. §§465, 466, 476, conferred income tax exemptions for the income of an Indian derived from other Indians' land. 625 F.2d at 915-916. In Jourdain, the Eighth Circuit concluded that a treaty provision protecting Indians from "molestation by the United States" did not preclude income taxation of a tribal official's salary. 617 F.2d at 508-509. In LaFontaine, the Eighth Circuit found that the taxpayer, while citing more than thirty treaties, was unable to point to any provision therein exempting his income from taxation. 533 F.2d at 382.

otherwise but, at the least, an ambiguity exists, sufficient to call into play the rules of construction relating to ambiguous treaty and statutory provisions. Moreover, such an ambiguity makes the language arguably a tax exemption and so requires that the purpose and policy of the treaty be examined to determine whether a tax exemption does exist.

As discussed above at pages 3-4, the right to fish under the Stevens treaties includes the right to fish commercially and thus necessarily the right to earn income from fishing. Commercial fishing under the Stevens treaties, unlike many other economic activities in which Indians might engage, is thus specifically and expressly protected from interference by the United States.

As to the understanding of the Indian treaty negotiators which, as discussed above, the Supreme Court has considered critical to the proper construction of treaties, it is no more likely that the Indians understood that the federal government would tax their fishing right than that they understood that future states would be able to impose a charge upon it. To the contrary, the Indians were assured that they would be able to fish and trade as they had prior to the treaties, see p. 4, supra, when they paid no taxes and were not required, in any other manner, to turn over a portion of their fishing catch or proceeds to the government.

Accordingly, in my view, the rules of treaty and statutory construction relied upon by the Supreme Court in Fishing Vessel, Tulee, and Capoeman require the conclusion that the Stevens treaties reserved to the Indians the right to fish free from taxation, including federal income taxation.

The question remains whether the later-enacted Internal Revenue Code abrogated or modified this treaty right, because Congress, unlike the state legislatures, has the power to abrogate treaties with Indians. Lone Wolf v. Hitchcock, 187 U.S. 553 (1903).

In Capoeman, the Supreme Court concluded that the Internal Revenue Code did not modify the federal government's undertaking in the General Allotment Act to hold allotments free of taxation in order to fulfill the purpose of that Act. 8/ Similarly, the Internal Revenue Code, in my view, did not modify the obligation undertaken by the federal government in the Stevens treaties to recognize the fishing rights reserved to the Indians. As the Supreme Court has stated, "While the power to abrogate [treaty] rights exists . . . 'the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress.'" (citing, inter alia, Squire v. Capoeman.) Menominee Tribe v. United States, 391 U.S. 404, 412-413 (1968). In Menominee, the Court held that a statute terminating the federal relationship with the Menominee Tribe did not abrogate the tribe's treaty hunting and fishing rights even though those rights derived from a treaty provision creating the tribe's reservation and the

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8/ "It is unreasonable to infer that, in enacting the income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would . . . be 'at the least a sorry breach of faith with these Indians.'" 351 U.S. at 10.

reservation itself was extinguished pursuant to the termination act. The Court, as it said, "decline[d] to construe the Termination Act as a backhanded way of abrogating the hunting and fishing rights of these Indians." 391 U.S. at 412. The Court reiterated the principle of Menominee in Fishing Vessel, while holding that a 1930 agreement between the United States and Canada did not implicitly extinguish the Indians' treaty right. "Absent explicit statutory language," the Court stated, "we have been extremely reluctant to find congressional abrogation of treaty rights." 443 U.S. at 690.

One court has found an implied limitation upon Indian treaty hunting and fishing rights in the Eagle Protection Act, 16 U.S.C. §§668-668d. United States v. Fryberg, 622 F.2d 1010 (9th Cir. 1980), cert. denied, 449 U.S. 1004. 9/ Although the court acknowledged the lack of express language in the Eagle Protection Act abrogating or modifying the treaty, it relied upon a body of evidence in surrounding circumstances and legislative history which it believed indicated that Congress did intend that the act apply to treaty Indians, and upon the well-established principle that reasonable and non-discriminatory conservation statutes apply to treaty rights when such application is necessary to achieve the conservation purpose of the statutes. 10/ The court also noted that the modification of the Indians' hunting rights was relatively insignificant because eagles had never provided the Indians with "any commercial benefit or . . . subsistence value." 622 F.2d at 1014. Rather, the court noted, the only apparent reason to hunt eagles was for religious and ceremonial purposes, and the act contained an exception permitting use of eagle specimens for religious purposes. Id.

The situation with respect to taxation of treaty fishing income is clearly distinguishable from that addressed in Fryberg. The treaty modification which would be implicated by application of the federal income tax to income from treaty fishing is significant because it would diminish the value of the right to fish commercially, a right which, as discussed above, was clearly reserved to the Indians by the treaties. In effect, it would represent a taking by the United States of a portion of the right it guaranteed to the Indians. Moreover, unlike the conservation measures addressed in Fryberg and the Puyallup cases, supra, at 3-4, whose effectiveness depends upon their being applicable to everyone, the federal income tax can achieve its purpose even though it does not tax every source of income. The "necessity" rationale supporting application of conservation laws to treaty rights is therefore lacking in the case of tax laws. Accordingly, under the principles of Capoeman and Menominee, absent more explicit language than is present in the Internal Revenue Code, Congress should not be deemed to have modified the Stevens treaty fishing rights nor to have limited or undermined the federal government's undertaking in those treaties.

9/ The Eighth Circuit reached the opposite conclusion in United States v. White, 508 U.S. 453 (8th Cir. 1974), stating that "it was incumbent upon Congress to expressly abrogate or modify the spirit of the relationship between the United States and the Red Lake Chippewa Indians on their native reservation." Id., at 457-458.

10/ See cases cited supra at p. 4.

Strom and Earl are Incorrect

As I mentioned at the outset, the only two court decisions on federal income taxation of treaty fishing income have concluded that such income is subject to tax. *Strom v. Commissioner*, 6 T.C. 621 (1946), *aff'd per curiam*, 158 F.2d 520 (9th Cir. 1947); *Earl v. Commissioner*, 78 T.C. 1014 (1982).

The *Strom* decision predated both *Squire v. Capoeman* and the *United States v. Washington* series of cases. The case involved on-reservation fishing by two members of the Quinault Tribe. The Tax Court apparently considered only Article II of the Quinault treaty, 12 Stat. 971, which authorized the setting aside of a reservation (and by implication exclusive fishing rights therein) for the Quinaults, and not the explicit language in Article III reserving off-reservation fishing rights, which is the language that, as discussed above, creates the tax exemption. 11/ In any event, the court analyzed the case by reference to two Supreme Court cases holding taxable a competent Indian's share of tribal oil and gas royalty income and an Indian's investment income. 12/

The third case relied upon by the Tax Court in *Strom*, an earlier Tax Court decision affirmed by the Tenth Circuit, held that an Indian's restricted land and income therefrom was subject to the federal estate tax. 13/ In light of *Capoeman* and subsequent decisions, this case is not presently followed by the IRS. *See* Rev. Rul. 69-164, 1969-1 C.B. 220.

Applying these three cases, the Tax Court made several statements in support of its conclusion which, after *Capoeman* and *Fishing Vessel*, are unpersuasive. First, the court stated that there was no express exemption from tax in the treaty. As discussed above at pp. 5-9, we now know from *Capoeman* and its progeny that a tax exemption, although it must derive from specific language in a treaty or statute, need not be expressly couched in terms of nontaxability. Second, the court considered it significant that the fishing income at issue was in the "untrammeled possession" of the petitioners.

11/ Although the Article III language ostensibly applies only to off-reservation fishing, the Supreme Court held in *Fishing Vessel* that it also applies to on-reservation fishing, to the extent, at least, that the Indians' on-reservation catch counts in their 50% allocation. 443 U.S. at 687.

12/ *Choteau v. Burnet*, 283 U.S. 691 (1931); *Superintendent of Five Civilized Tribes v. Comm'r*, 295 U.S. 418 (1935). Both cases were distinguished by the Supreme Court in *Capoeman*, 351 U.S. at 9 and n.19. At the time *Strom* was decided, the Supreme Court appeared headed toward a rule that all or essentially all Indian income was taxable, a clear change of direction from the earlier understanding, derived from administrative rulings, that no Indian income from tribal or allotted lands was taxable. It was not until ten years after *Strom* that the Supreme Court in *Capoeman* limited the scope of the *Choteau* and *Superintendent* holdings and signalled a return of the pendulum to a point between the two extremes. For an historical analysis of the tax cases, *see* Putzi, "Indians and Federal Income Taxation," 2 N.Mex. Law Rev. 200 (1972); Fiske and Wilson, "Federal Income Taxation of Indian Income from Restricted Lands," 10 Land and Water Law Rev. 63 (1975).

13/ *Landman v. Comm'r*, 42 B.T.A. 958 (1940) *aff'd* 123 F.2d 787 (10th Cir. 1941) *cert. denied* 315 U.S. 810.

Capoeman sets no requirement that income from allotments (as distinguished from the allotments themselves) must be in restricted status in order to be tax exempt. Third, although it conceded that the federal government could not directly tax exercise of the fishing right, the court concluded that the government could tax income from fishing because a tax on income was not a burden on the fishing right. As discussed above at p. 7, the same distinction between a direct tax and a tax on income was argued by the government in *Capoeman* and rejected by the Supreme Court. Moreover, after *Fishing Vessel*, it is clear that the fishing right reserved by the treaties encompassed the right to sell fish, so that an income tax is, in fact, a burden on the fishing right. *See supra*, at pp. 10-11. Finally, the court appears to have premised its conclusion in part upon an error of fact, in that it apparently believed that the Indians at treaty time had not engaged in substantial commercial fishing. The court stated, for instance, "It is a far cry from the fishing operations of the members of an uncivilized tribe of Indians at the time of the execution of this treaty, and the commercial fishing business now carried on by the petitioners." 6 T.C. at 627. As we now know, however, the treaty Indians did in fact rely heavily upon fish for commercial purposes. *See supra* at 3-4.

In my view, the law as it has developed since *Strom* and the facts about Indian fishing that have come to light since *Strom* have undermined that decision so completely that it must now be considered unsound precedent.

Earl v. Comm'r, *supra*, is a 1982 Tax Court decision which reached the same conclusion as *Strom*. For a number of reasons, I do not believe it is persuasive authority. First, the opinion reflects the fact that the petitioner, who had no attorney, was unable to present the court with an adequate analysis of the treaties. It could not be expected, of course, that the Tax Court, which normally does not interpret treaties, would have, on its own, any appreciable familiarity with the long and complex litigation involving the Stevens treaties. Consequently, although the court briefly alluded to the lower court decisions in *United States v. Washington*, it failed to even mention *Fishing Vessel* or any of the other Supreme Court decisions interpreting the treaties and also failed to demonstrate an understanding of the principles of those cases.

Further, the Tax Court, as might be expected, relied heavily on *Strom*, which is, in my view, no longer good law. The court also interpreted *Capoeman* as essentially limited to its facts, contrary to the interpretation given that case by the federal courts of appeal. *See* discussion, *supra*, at pp. 7-9. Evidently, it was this interpretation of *Capoeman* that led the court to conclude that because the petitioner's fishing rights were not individually owned in the sense an allotment is individually owned, there could be no tax exemption. The court cited *Fry*, *Anderson* and other cases discussed *supra* at pp. 7-9 as support for that interpretation, based on the holdings in those cases that, in the circumstances at issue, income earned by Indians from tribal land was not exempt. The basis for those decisions, however, as discussed above, was not that income from tribal property is *ipso facto* taxable, but that the General Allotment Act exemption did not apply and, second, that no other exemption could be found in treaty on statute. The second basis for those decisions makes them inapplicable to treaty fishing income, for which an exemption is found in the treaties. For these reasons, particularly the lack of treaty analysis, I do not consider the *Earl* decision authoritative.

SAY ROSE BURRO

ROSBORO LUMBER COMPANY

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July 18, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization --as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- † Repealing Section 89;
- † Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- † Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Michael L. McCrady
Controller

MLM:sll

233 WILSHIRE BOULEVARD, SUITE 790 SANTA MONICA, CALIFORNIA 90401 (213) 458-1574

scope INDUSTRIES

July 19, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen, Senate Office Building
Washington, DC 20510

Subject: Hearing on Technical Corrections - July 13, 1988

Dear Ms. Wilcox:

We are concerned with the effect Section 89 will have on our Company's benefit programs. Although we understand and believe that non-discrimination is appropriate and a worthy goal, we find that Section 89 will be a serious and costly administrative burden to our Company.

Although we are a fairly small company [approximately 150 employees], we have employees scattered in ten states. To provide group medical coverage to these employees, we have seven [7] separate HMO contracts, each covering separate geographic areas, and we have an indemnity contract which provides coverage for employees in nine [9] locations where HMO coverage is unavailable because we have too few employees to qualify for HMO coverage or are unable to enroll enough employees to qualify for a semi-reasonably priced indemnity group policy.

Now, after struggling to organize group coverage that meets the requirements of insurance companies and HMO organizations, we must face Section 89 tests. We do not know precisely how many groups and tests this will require, but estimate it will be in excess of 24 for medical insurance. We haven't yet considered our group life tests.

We feel we are being put in a "Catch 22" between the requirements of local HMO's, group indemnity underwriters, and the U.S. Government's Section 89. By splintering our work force into so many group contracts and sub-group tests within the contracts, we are bound to fail the Section 89 tests on some coverages. The result may or may not show discriminatory coverages.

But, whatever the result of the Section 89 tests, it will be by chance and by insurance industry pricing bases for different geographic locations rather than designed discrimination on the part of the Company.

It seems unfair. We are unable make the plans uniform; the insurance industry prevents that. So, our remedy is to modify and reduce the benefits or eliminate the Company contribution.

Please consider methods for relief or delayed implementation of Section 89 for employers such as ourselves who have small work forces in several geographic areas.

Very truly yours,

SCOPE INDUSTRIES

John J. Crowley
Vice President

JJC:dec

Seattle Post-Intelligencer

WILLIAM R. COBB
BUSINESS MANAGER

July 18, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1968, places an overwhelming data gathering and administrative burden on us as a plan sponsor. Much, if not most, of the data required is difficult to obtain and it is my understanding will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when we are already finding the cost of health care to be exorbitant.

The resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. It will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as we are required by union contract. Is it fair to penalize employers who provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the costs of gathering and maintaining data, as well as actual testing, are staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

101 ELLIOTT AVENUE WEST SEATTLE, WASHINGTON 98119 206/448-8057

In order to provide a measure of relief to plan sponsors-especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after the Treasury issues final regulations;
- Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors will be greatly appreciated.

Sincerely,

William R. Cobb
Business Manager
Seattle Post-Intelligencer

WRC:mc

cc: Senator Dan Evans
Senator Brock Adams
Congressman John Miller

The Section 89 Coalition

July 11, 1988

Hon. Lloyd Bentsen
Chairman
Senate Finance Committee
Washington, D.C. 20510

Dear Mr. Chairman:

The Section 89 Coalition is a voluntary coalition of both small and large employers, labor unions, managed health care plans, health insurers, and benefits consultants who have banded together to communicate their concerns about Section 89 to Congress. The Coalition appreciates the changes to Section 89 included in the Ways and Means version of the technical corrections bill, H.R. 4333, and views them as positive steps forward. Before employers can realistically comply with the policies of Section 89, however, much work remains to be done, including work on simplification, safe harbors and health policy issues raised by the rules. The comments below represent our specific areas of concern and highlight major issues that need to be addressed in the current Section 89 requirements. We would appreciate the inclusion of this letter and its attachments in your hearing record on H.R. 4333.

The members of the Coalition share common concerns about Section 89:

- The Coalition supports Congress' goals of discouraging discrimination in employer-provided health and group-term life benefits, but believes that the statute is overly complex, too expensive to administer, and will drive employers to limit their plans by eliminating subsidized family coverage, reducing available health options and eliminating plan choices for employees.

- The membership is greatly concerned about the imminent effective date of Section 89. With little time remaining, employers still do not have regulatory guidance on critical issues under Section 89, including, for example, separate lines of business and former employees. In view of these unanswered questions and the changes necessary to make Section 89 more workable, the Coalition requests sufficient lead time for employers to comply with a revised Section 89.

- The Coalition has also expressed a willingness to explore the concept of a "phased implementation" of the rules. This would be in accord with some expressed Congressional concerns that an outright delay of the January 1, 1989, effective date included in the 1986 tax reform bill be avoided.

- The Coalition believes that both the tax and health policy goals of Section 89 are better served by simplifying and clarifying the nondiscrimination rules, and has demonstrated its willingness to assist Congress in developing reasonable and practical revisions to Section 89.

In addition to these general concerns, the Coalition has a number of specific, major issues in the current statute that we wish to discuss.

1. Safe Harbors:

The Coalition supports the adoption of appropriate safe harbors that allow employers to demonstrate compliance with section 89 on a simplified basis. No safe harbors are contained in the Ways and Means bill. The Coalition's initial set of safe harbors are attached as Exhibit 1.

2. Separate Lines of Business:

The Coalition supports having interim guidelines for determining separate lines of business pending the availability of both regulations and rulings. The Ways and Means bill does not address this need. Attached (as Exhibit 2) are the Coalition's preliminary suggestions. The attached exhibit includes a transition rule for allocating headquarters employees, a permanent rule is also needed. In addition, operating units which are at least 35 miles apart should automatically be considered geographically separate. Finally, the 75 percent rule for allocating employees in the Ways and Means bill should be modified as follows: An employee providing at least 75 percent of his services to a line of business need not be allocated to that line if he is a member of a functional unit that works for multiple lines of business (i.e., the unit does not provide at least 75 percent of its services in the aggregate to any one line), and no more than an insubstantial number of employees in the unit provide at least 75 percent of their services to a single line of business.

3. Time for Testing and Sampling:

The Coalition believes that absolute one-time-per-year data gathering is necessary. An employer should not be required to track mid-year enrollment changes by highly compensated employees ("HCEs") as mandated by the Ways and Means bill if, under the plan, elections by these employees to change benefits may only be made in the event of a change in family status. With respect to sampling, the Coalition believes the Ways and Means bill should be modified to reduce the required confidence level to 95 percent and to increase the allowable margin of error to five percent.

4. Group Term Life Benefits:

As described in more detail in Exhibit 3, there are significant problems with application of section 89 to group-term life benefits: the uniform definition of compensation, by itself and in conjunction with the definition of a plan, is unworkable and procedures for determining the employer-provided benefit are unclear. These problems are not addressed in the Ways and Means bill. As a result, the application of section 89 to group-term life benefits should be delayed. On an interim basis, nondiscrimination rules applicable to group-term life benefits under pre-Tax Reform law should be continued.

5. Sworn Statements:

In addition to the changes in this area in the Ways and Means bill, the Coalition believes that, rather than requiring the statutorily mandated sworn statements regarding an employee's family status, an employer should be allowed to apply the tests as if some percentage of its non-HCEs had families not covered elsewhere and some higher percentage of its HCEs had families not covered elsewhere. Also, the Ways and Means bill should be modified so that evidence of insurability may be required for opt-outs that subsequently want to enroll in the plan if the employer requires such evidence of other similarly situated late entrants.

6. 90/50 Test:

The current cliff in the 90/50 test's sanction should be eliminated. Instead, if less than 90 percent of the nonhighly compensated employees ("NHCEs") have benefits available, then benefits available to HCEs in excess of a certain percentage of the benefits available to NHCEs should be taxable excess benefits. Under this proposal, the percentage would be 100 percent multiplied by a fraction, the numerator of which is the percentage of NHCEs with benefits at the reference level elected, and the denominator of which is 90. This issue is not addressed in the Ways and Means bill.

7. Comparability and Aggregation:

The Coalition believes the proposed comparability standards are too high. 80 percent comparability should apply to all tests, and this should apply without any increase in the 80 percent coverage standard under the alternative test unlike under the Ways and Means bill. In addition, the aggregation rules should be liberalized. For example, it should be permissible to aggregate employee-only health coverage with a benefit other than health (in order to test that benefit) if both employee and family health coverage pass when tested separately. This issue is not addressed in the Ways and Means bill.

8. Former Employees:

In order to avoid undue complexity, benefit increases for employees terminating before January 1, 1989 should be tested solely under a subjective test, such as the nondiscriminatory terms test. This would modify the rule under the Ways and Means bill. Also, federally mandated increases, such as the Medicare Catastrophic maintenance of effort provision, should be disregarded. This issue is not addressed by the Ways and Means bill.

In addition to these areas of major concern, a list of the Coalition's positions on other technical Section 89 issues is attached as Exhibit 4.

The Coalition looks forward to working with the Finance Committee and the Joint Tax Committee as this legislation moves through the Congressional process. We appreciate your willingness to help make this law more workable for employers.

Sincerely,

Carol Kelly

Carol Kelly
Chairperson

Submission of the Securities Industry Association to the Committee on Finance, U.S. Senate

The Securities Industry Association ("SIA") represents over five hundred seventy-five leading investment and brokerage firms headquartered throughout the United States and Canada, which collectively account for approximately 90% of the securities transactions conducted in North America. The activities of SIA Members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter marketmaking, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on the capital market as well as on investment decisions by corporations and investors.

The SIA opposes the provision of H.R. 4333 approved by the Committee on Ways and Means of the House of Representatives which would reduce the corporate dividends received deduction for corporations owning less than 20 percent of the payor corporation from the current 70 percent to 55 percent in 1989, 52.5 percent in 1990, and 50 percent in 1991 and subsequent years. The House provision is based on a faulty understanding of the purpose of the dividends received deduction and an inadequate grasp of the tremendous impact the House provision would have on the capital markets. We urge the Senate to reject this provision.

This Committee has given consideration to the tax treatment of the dividends received deduction during the last several years, and SIA has been pleased to have worked with you and the staff. Although we opposed certain of the proposals in the Senate Finance Committee staff report on the reform of corporate taxation published in 1983, the changes ultimately enacted in the Tax Reform Act of 1984 curbed abuses but reflected an appreciation of the fundamental importance of the dividends received deduction.

The description of the provision prepared by the staff of the Joint Committee for the House Ways and Means Committee indicates that the proposal is intended to distinguish between corporate dividends received from a corporation that is so closely related as to be its "alter ego" and dividends received from a corporation in which there is a portfolio investment. This explanation reflects a serious misunderstanding of the purpose of the dividends received deduction.

Unlike the consolidated return provisions, the dividends received deduction is not intended to vary with the degree of common control of two corporations. Rather, the dividends received deduction is an integral part of the "classic" two-tier system of taxing corporations and shareholders, which ensures that corporate earnings are not triple taxed. In enacting the corporate income tax, the Congress decided that corporate profits should be taxed twice, but only twice--once at the corporate level, when the corporation pays taxes on its earnings, and again when those earnings are ultimately paid out as dividends to individual investors. The corporate tax is not intended to be imposed every time an intermediate corporate distribution is made. To do so would be to tax multiple times earnings that have already been fully taxed at the corporate level.

The Congress has historically recognized the importance of the dividends received deduction, which was effectively 100 percent from 1917 to 1935 and remained at 85 percent until 1986. In 1987, the Senate rejected the changes in the dividends received deduction approved by the House Ways & Means Committee. Ronald Pearlman, who was then Deputy Assistant Secretary of the Treasury for Tax Policy and is now Chief of Staff of the Joint Committee, recognized that the dividends received deduction fills this crucial function in his 1983 testimony before this Committee, in which he opposed an across-the-board extension of the holding period to qualify for the deduction. Statement of Ronald A. Pearlman, Hearings before the Committee on Finance United States Senate, 98th Cong., 1st Sess. (October 24, 1983) at 33. Many academic and professional commentators advocate the retention or even the expansion of the dividends received deduction as a means of achieving integration.

The dividends received deduction is thus not a "loophole" or special-interest provision for corporate portfolio investors. It is the cornerstone of a coherent system of corporate taxation. Other countries have adopted some kind of integration system to reduce the burden of double taxation of corporate earnings. Of ten foreign industrialized countries, seven (Belgium, Canada, France, Italy, Japan, Germany, and the U.K.) have instituted systems specifically designed to reduce the problem of double taxation.*

Despite its importance, the dividends-received deduction has been eroded in recent years in the search for revenue. While the need for tax revenue is important, and every taxpayer must contribute its fair share, the dividends received deduction has borne a disproportionate burden.

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* Unpublished study, SIA/Arthur Andersen & Co., April 1985.

Before the Tax Reform Act of 1986, intercorporate dividends were subject to an effective tax rate of 6.9%. If the House provision is enacted, that rate would increase by nearly 250% to 17% in spite of the large personal and corporate tax rate cuts enacted by the 1986 Act.

Moreover, it is misleading to focus on the rate of tax paid by the recipient corporation. The dividends received deduction, as its name implies, is available only with respect to dividends. The point here is that dividends which are distributed out of earnings and profits of the distributing corporation reflect previously taxed income. The aggregate tax burden on the income which generated the earnings and profits which made the dividend possible would be 45.22% if the House proposal were to be enacted at current rates in 1991. If amounts are subsequently distributed by the recipient corporation to an individual shareholder in the 28% bracket, the overall tax burden would be 60.56%. Incidentally, these percentages do not take into account any effect the dividends received deduction claimed by the recipient corporation has on its earnings and profits, which in turn supports the dividend treatment of its distributions.

This is not a matter of merely theoretical interest. The proposed reduction in the dividends received deduction would have a serious impact on the capital markets and on the businesses that rely on those markets to raise the funds necessary to invest and grow. Decreasing the dividends received deduction means that equity in all its forms is less attractive to investors. As a direct result, issuers of preferred stock, for example, must increase the yield of the stock in order to raise the same amount of capital. Increasing the cost of equity capital in this way has serious consequences throughout the economy.

One immediate consequence will be to create a tax-driven bias for issuing debt rather than equity.

Increasing the cost of equity financing makes debt doubly attractive. Not only will debt financing be relatively cheaper, but interest payments on debt are deductible. Concern has been expressed recently that the U.S. economy is already overleveraged.

Statistics show that U.S. companies are now burdened with unprecedented amounts of debt. The 1980s have seen the debt-to-net worth of nonfinancial corporate America escalate to record levels.* The debt-to-net worth ratio of nonfinancial corporate America stood at 52.0% and 56.3% in 1986 and 1987 on a current cost basis (84.6% and 91.6% on a historical cost basis), the highest this ratio has reached since the start of the series in 1948. So too, the debt-to-equities ratio, which average about 42.9% in the 1960s, escalated sharply in the 1970s and has remained over 70% in the 1980s. In 1986 and 1987, the debt-to-equities ratio of nonfinancial corporations was 73.3% and 79.0%, respectively. A high load of debt increases the risk of bankruptcies should the economy suffer a recession. We can ill afford legislation which increases the tax bias favoring debt financing and fosters a further deterioration in the balance sheets of American business.

The major issuers of high yielding common and preferred stock have been utilities and banks, including thrifts. In the first four months of this year, 81% of all preferred stock offerings were made by firms in these industries and it is estimated that 80%-85% of the buyers of preferred stock are corporations. Utilities and banks are particularly hard-pressed for capital in the depressed areas of the country such as the Southwest. The increased cost of funds will be passed on to consumers in the form of utility rate increases and higher rates on mortgages and small business loans.

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* Balance Sheets for the U.S. Economy, 1948-1987, Board of Governors of the Federal Reserve System, April 1988.

The burden of a further reduction in the dividends received exclusion is a real one. For example, issuers sold $13.9 billion of new preferred stock in 1986 when preferred stock was yielding 8.76% on average, the federal corporate tax rate was 46% and the dividends received deduction was 85%. Purchasers, therefore, received an 8.16% effective after-tax yield on that stock. If the dividends received deduction had been the proposed 50%, issuers would have to have afforded investors a 10.59% dividend (versus the actual 8.76% average yield) in order to maintain that 8.16% after-tax yield. Assuming 100% is purchased by corporations, this translates into a 21% increase, or $255 million increase, in cash dividend payments over the $1,218 million in dividends actually paid on these new issues in 1986 alone!

Similarly, issuers sold $11.4 billion in new preferred in 1987 at an average yield of 8.37% for an after-tax yield of 7.70% to purchasers (when the dividends received deduction and corporate tax rate were both lower, at 80% and 40%, respectively). Here, issuers would have had to raise the yield to 9.63% (up from 8.37%) to maintain that 7.70% effective yield if the deduction were only 50%. That is a 15% increase in cash payments, or $143 million more, than the $954 million in dividends actually paid for this new stock in 1987 alone (assuming all outstanding at the year's onset).

Finally, in the first half of this year (when the exclusion was 70% and the tax rate 34%), issuers sold $3.4 billion of new preferred at an average yield of 9.04%, for an after-tax yield to purchasers of 8.12%. If, again, the dividends received deduction had been reduced to 50%, issuers would have had to sell that same preferred with a

9.78% yield (versus the 9.04% actual yield) for the purchasers to have maintained an 8.12% after-tax yield. That is an additional $25 million in cash dividends, or 8% more, for the new stock sold in the first half of this year alone.

One might note that the additional dividends payments seem to be smaller in each additional year. What may be happening is that the reduction in the exclusion from 85% to 80% to 70% is affecting corporate purchasers' decisions to buy new preferred despite lower tax rates overall. This may be impairing issuers' ability to sell these securities, causing the amounts of new preferred stock issues to decline drastically. Based on this year's first half, the amount of preferred that will be issued by December of this year will be half that sold in 1986. Assuming issuers' financing needs are constant (if not rising), if they cannot sell equity they will raise their capital through the issuance of new debt, on which interest payments are tax deductible.

In addition, the increase in the cost of equity financing will most affect small businesses and new ventures, which are least able to turn to the debt markets as an alternative. These are the same small businesses and startup companies that have been the major source of new jobs in the 1980's. Increasing the cost of capital for American business also puts U.S. industry at a competitive disadvantage in international markets. In an era of burgeoning trade deficits, it is counterproductive to create an additional tax burden on the cost of funds.

The dividends received deduction has undergone significant scrutiny by the Congress since 1983 and has already borne a large share of the burden of recent tax reform. The House provision would give a further shock to equity markets that have been in the doldrums since last October. We urge this Committee to refuse to follow the House in this ill-considered and ill-timed project.

Signet Banking Corporation
7 North Eighth Street
PO Box 25970
Richmond VA 23260-5970
804-771-7467

Mrs Mary P Carlton
Executive Vice President

SIGNET

July 25, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox,

I am writing to you regarding technical correction legislation (S. 2238) as it concerns Section 89 of the Internal Revenue Code.

Signet Banking Corporation recognizes the legitimacy of nondiscrimination as a policy goal for legislators, however "tax simplification" is an equally desirable policy goal. We believe there are less complicated means of measuring nondiscrimination than the labyrinthine mathematical approach of Section 89.

Signet Banking Corporation allows its employees to select from among two to five different health plans (depending on geography) and to select either family or individual coverage. Over 80 percent of eligible employees elect some form of coverage. Employee surveys have revealed that the vast majority of those employees waiving coverage do so because their spouse receives cheaper, often no cost, coverage from the spouse's employer (often a branch of the Federal government).

Additionally, our employee surveys indicate that while employees have individual preferences, the various health plans (indemnity and HMO's) are viewed as similar alternatives of like cost. Indeed our enrollment is nearly 50-50 between HMOs and indemnity plans. Further, Medical benefits are viewed as the most valuable qualified plan benefits our employees receive.

Despite all this, Signet Banking Corporation cannot pass the so-called safe harbor test of Section 89 (f) because apparently (the current lack of regulations prevents us from knowing for sure) Section 89 considers us to be offering 26 different health and 6 different dental plans! I can assure you our employees do not think they have 32 choices, but are instead selecting from three health plan options.

Section 89 (f) also creates confusion when considering the definition of a plan contained in Section 89 with other Federal legislation mandating the offering of HMO's. We find ourselves caught in a web of regulations which produce an impossible situation. We cannot pass Section 89 (f) if we comply with the HMO Act, and we cannot comply with the HMO Act and meet the Section 89 (f) test.

Instead of being able to demonstrate compliance with a simple rule applied to all our employees, we will now have to go through a series of three sub-tests, each more mathematically elaborate than the next, and do so 32 times!

Further, we would like to proceed with the testing, but we cannot because the necessary regulations have not been issued, almost two years after passage of the legislation and just five months before the implementation date.

Signet, like many employers, is giving serious considerations to eliminating as many medical plan options as we can in order to simplify our recordkeeping and administration time and expenses. This shrinking of employee choice is likely to occur nationwide and is certainly an unfortunate and unintended effect of this legislation.

We strongly urge you to reconsider the testing requirements of Sections 89 and postpone their implementation until at least 180 days after the issuance of the regulations.

Mary P Carlton
Mrs. Mary P. Carlton
Executive Vice President

SISTERS OF PROVIDENCE
SERVING IN THE WEST SINCE 1856

PROVIDENCE MEDICAL CENTER
4805 NORTHEAST GLISAN STREET
PORTLAND, OREGON 97213-2967
PHONE (503) 230-1111

July 18, 1988

Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D. C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Correction
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization - as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards - you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

PROVIDENCE MEDICAL CENTER

Kenneth D. Maestretti
Assistant Administrator
Human Resources

Stimson Lumber Company

Executive Offices / 520 Southwest Yamhill Street / Suite 308 / Portland, Oregon 97204

July 20, 1988

Laura Wilcox,
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Bldg.
Washington, DC 20510

Dear Ms. Wilcox:

Re: Comments for the Record, July 13, 1988 Hearing on Technical Corrections IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

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Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex - yet as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received

Stimson Lumber Company, *Forest Grove, Oregon* / Forest Fiber Products Company, *Forest Grove, Oregon*,
Northwest Petrochemical Corporation, *Anacortes, Washington* / Miller Redwood Company, *Crescent City, California*,
Miller Redwood Company, Plywood Division, *Merlin, Oregon* / Rellim Redwood Company, *Crescent City, California*

any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated", but who are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards - you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Very truly yours,

STIMSON LUMBER COMPANY

Darrell H Schroeder

Darrell H. Schroeder
President

DHS/njj

Skagit Valley
Hospital
and Health
Center

July 19, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Members of the Senate Finance Committee:

I am writing in regard to the July 13, 1988, hearing on Technical Corrections to IRC Section 89, and my comments are for the record.

Skagit Valley Hospital and Health Center is a Public District Hospital with a publicly elected Board of Commissioners organized under the laws of the State of Washington. The Hospital is operated in a very open environment and certainly in an environment of non-discrimination. We also operate in a very challenging financial environment as virtually all hospitals are in the country and certainly in this part of the state, and find that the burden of complying with a very complex act is proving very difficult at best.

As you are aware, there is a whole new industry building up to assist employers, for a price of course, to learn how to comply with Section 89. I am faced with the prospect of sending people to a variety of meetings to try to understand this and probably will have to employ a firm to come in to provide the expertise which my own employees do not have and cannot have the time to obtain to attempt to comply with the act. I cannot believe that the United States Congress intended employers to have to go to this extent and particularly those such as ours who have tried very diligently to not discriminate in any of our employment practices. Is there no easier way than to come up with a law so complex that most employers cannot understand it to provide for non-discrimination in our employee and benefit practices?

Further, I am advised that these incredibly complex rules are still lacking the necessary Treasury regulations. The little that I do know about Section 89 would lead me to believe that there are a number of major outstanding issues upon which the Treasury has not even provided guidance at this writing. Yet, the time to meet these new requirements is becoming increasingly short.

1415 East Kincaid
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Mount Vernon, WA
98273-1376
(206) 424-4111

Therefore, I would respectfully request that you either consider repealing Section 89, delaying Section 89 for a year after the Treasury issues it's final regulations, or greatly simplifying the rules by perhaps establishing several so-called "safe harbor" alternatives".

Thank you for your consideration of my request.

Sincerely,

Patrick R. Mahoney
Administrator

cle
cc: Senator Dan Evans
Senator Brock Adams
Congressman Al Swift

Southwestern Bell Corporation

One Bell Center
St. Louis, Missouri 63101
Phone (314) 235-7000

Guy E. Miller
Vice President
Human Resources

July 22, 1988

The Honorable Lloyd Bentsen, Chairman
Senate Finance Committee
United States Senate
Washington, D.C. 20520

Dear Senator Bentsen:

The current version of the Section 89 legislation is of grave concern to Southwestern Bell Corporation (SBC). SBC is supportive of legislative action aimed at promoting the nondiscriminatory delivery of welfare benefits. However, SBC firmly opposes the method dictated in the Section 89 statute.

The Senate Finance Committee will soon be conducting hearings on the Technical Corrections proposed to TRA 86. The significance of the Section 89 nondiscrimination procedures should not be underestimated. As currently enacted, Section 89 nondiscrimination procedures will create severe problems for Southwestern Bell Corporation and other large employers.

The statute, as it is written today, goes to exaggerated lengths to impose complicated and costly testing procedures premised on identifying and penalizing discriminatory action. The detailed nature of the tests reflects a basic distrust of plan sponsors. This is unfair and unwarranted. Rather than employers seeking innovative ways to optimize resources and satisfy the individual needs of its employees, the effect of Section 89 could be compliance at the cost of reducing employee benefit options and coverage.

The hearing on Technical Corrections provides an opportunity to enact safe harbors and simplification rules, without which SBC and many other large employers will have to invest a wealth of benefit resources proving that their welfare plans are not discriminatory. Further, the expense of proving compliance will result in a tax expenditure by the federal government.

Further, the expense of proving compliance will result in a tax expenditure by the federal government.

Included in the pages that follow is a summary of the benefit environment at SBC, a brief discussion of the problems inherent to the current version of Section 89 and a statement urging legislative relief.

On behalf of Southwestern Bell Corporation, I implore you and each member of the Finance Committee to consider the wasteful drain on company resources and the unfortunate consequences of implementing the current version of Section 89.

This correspondence and the attendant information is respectfully submitted for inclusion in the hearing file.

Sincerely,

D. E. Miller

SBC BENEFIT ENVIRONMENT

Prior to 1984, Southwestern Bell Telephone Company operated in five states as a member of the AT&T Bell System. Today, some four years later, Southwestern Bell Telephone Company is a member of the Southwestern Bell Corporation family of companies operating in 50 states. Southwestern Bell Corporation consists of more than a dozen companies with 67,000 employees and 26,000 retirees. The companies range from fewer than 100 employees to almost 60,000.

The Bell System tradition of being a quality provider of benefits was passed on to SBC in 1984, when all of the Bell System benefit plans became SBC plans. Welfare benefits have since been expanded to better meet the needs of SBC's increasingly diverse employee family. Today, SBC offers a comprehensive program of quality welfare benefits, almost totally supported by company contributions. Last year, Southwestern Bell Corporation spent in excess of $287 million on welfare benefits for its employees and retirees. It is not surprising that a recent study comparing the value of benefits provided in 20 major industrial firms, ranked SBC benefits among the top 10-15% among major employer groups. While this is not a precise measurement, it confirms SBC as an industry leader in the provision of employee benefits.

Southwestern Bell understands the value of its human resources and has structured its welfare benefit programs to attract high participation from employees at all levels. Following are some general characteristics of the SBC health plans.

1. **A uniform level of eligibility requirements apply to active employees and pensioners.**

2. **Coverage continues during disability, up to age 65.**

3. **Dependent coverage is employer provided.**

4. **SBC pays 100% of the premium in company-sponsored plans and makes an equal contribution to HMOs.**

5. **The level of benefits provided is the same for all employees and retirees, regardless of level or salary.**

6. **Various plan and coverage options are provided (CustomCare, HMO, DMO). Selection is at the preference of the employee.**

These circumstances apply to most of the people, most of the time. There are, however, some minor EXCEPTIONS to the rule. The exceptions are not capricious and do not arbitrarily impact wage groups. The exceptions are structural and relate to service credit and certain leave of absence provisions available to employees. Once an employee achieves six months' service, SBC considers this a substantive working relationship and extends company paid welfare benefits.

Southwestern Bell also provides EXECUTIVE LEVEL coverage on a very restrictive basis. Executive level welfare plans were introduced to handle the special needs of the officers of the company and key senior managers. In the SBC family, this is less than 40 of the 67,000 employees. SBC understands this plan to be a violation of the nondiscrimination provisions and will voluntarily impute 100% of the cost of the plan to the participants.

As you can see, SBC benefit plans have been designed to make welfare benefits broadly available to its employees. SBC's benefit history and its current benefit practices meet the intent of Section 89.

PROBLEMS WITH SECTION 89

Requires Excessive Data Collection

The magnitude of the data collection effort cannot be overestimated. If the existing version of Section 89 is implemented, SBC would be required to develop an extensive data base to obtain and keep current over 100 fields of data for each of its 67,000 active employees and its 26,000 retirees. The data requirement inherent in Section 89 poses two major problems:

1. **Some of the information simply does not exist.** For example, SBC does not maintain the marital status of employees (for EEO purposes) nor is information on leased employees maintained.

2. **The information that does exist is not easy to retrieve.** For SBC, collecting the kind of information needed by Section 89 will require interrogating at least 12 payroll systems and retrieving files from 70 different carriers.

In addition, two of our smaller subsidiaries have employees covered by multiemployer plans. No detailed plan data is available covering these plans.

Exhibit 1 briefly lists some of the data employers will be required to obtain and keep current for testing purposes.

Definition of a "Plan"

Another complexity of Section 89 involves the definition of a "PLAN." Prior to Section 89, SBC had a simple and functional way of looking at welfare benefits. SBC provides health coverage consisting of a medical, a dental and a vision plan. In addition, there is a group term life insurance plan.

Looking just at the medical plan...SBC offers three arrangements. Employees are free to determine which of these arrangements best fits their individual situation. The company pays 100% of the cost of coverage for employees and their dependents, except for employees with less than six months of service or those working less than 24 hours a week. All employees will then fall into one of the coverage options listed in Exhibit 2.

Section 89 stipulates that, "for testing purposes, each level of benefit coverage within a medical or group term life insurance plan is considered to be a separate plan." What was thought to be one medical plan, with options to meet employees' needs, has multiplied into 824 plans (Exhibit 3). With the different medical plans offered by the smaller SBC subsidiaries, there could be approximately 900 medical plans.

This still does not account for the total SBC family. In two SBC subsidiaries, welfare benefits are provided through multiemployer plans. Once the Section 89 definition of a plan is applied to these situations, the total number of medical plans available in SBC will exceed 1000. The same process must be applied to the dental, vision and life insurance plans.

The existing version of Section 89 is explosive and will have a significant and unhealthy impact on the cost of administering employee benefits.

Increased Cost Due to System Development and Compliance Administration

SBC does not currently have a centralized benefit system. Such a system would be needed to track employee eligibility and coverage data. To develop such an extensive data base and associated testing programs would cost SBC over $1 million and would take at least 18 months to develop. This development effort could not be seriously undertaken until regulations were available.

The cost of Section 89, however, should not be limited solely to the $1 million plus required to develop an eligibility and data base management system. SBC will also have to increase its benefit staff to oversee the collection and consolidation of data from subsidiaries. Additional costs will also be incurred by subsidiaries and carriers to provide data to the Corporate staff.

Could Result in a Reduction of Benefits

Under Section 89, competitive and comprehensive benefit packages similar to SBC plans could fail the nondiscrimination tests because they offer (and pay for) several different levels of coverage for employees and dependents.

Employers with comprehensive welfare plans could simplify their testing procedure and more easily achieve compliance by drastically reducing the quality of its welfare benefits. For example, Southwestern Bell could immediately reduce the risk of noncompliance, as well as the cost of administering Section 89 by providing only one type of company paid medical benefit for employees only. This would eliminate all coverage for dependents and retirees. It would also eliminate all options for employees. This surely was not the desired impact of Section 89, yet it is our simplest compliance strategy and it will be the most acceptable outcome for some plan sponsors.

RELIEF FOR SECTION 89: SAFE HARBOR AND SIMPLIFICATION

The most unfortunate consequence of Section 89 is that the cost of data collection, data maintenance and actual nondiscrimination testing will far outweigh the cost of compliance. Health care expense is one of the fastest growing segments of the American economy. The nondiscrimination procedures compound the problem by generating empty overhead expense.

This problem can be remedied by enacting safe harbors that would evaluate the structural characteristics of a plan.

Employers such as SBC who provide welfare coverage that is clearly not discriminatory should not be burdened with extensive and otherwise unnecessary data collection and associated programming and administration cost. The safe harbors listed below (proposed by the Association of Private Pension and Welfare Plans (APPWP) and the Section 89 Coalition) are much needed.

Safe Harbor #1

A common health plan (such as an employer-wide indemnity plan or group of comparable plans), as well as any alternative plan (such as an HMO), will satisfy the 80% test if:

1. at least 80% of all employees (disregarding statutorily excluded employees) are eligible to participate in the common plan;
2. no employee contributions to the common plan (whether before-tax or after-tax) are required or permitted;
3. if an employee opts out of the common plan in order to join an alternative plan, the employer will contribute to the alternative plan an amount that is equal to the lesser of (a) the cost of coverage under the alternative plan or (b) the cost of coverage under the common plan (with actuarial adjustments permitted to reflect demographic differences); and
4. at least once a year, each participant is given the opportunity to leave any alternative plan and to enter the common plan (or to leave the common plan and to enter any alternative plan).

Safe Harbor #2

A common health plan (such as an employer-wide indemnity plan or group of comparable plans), as well as any alternative plan (such as an HMO), will satisfy the 80% test if:

1. at least 80% of all employees (disregarding statutorily excluded employees) are eligible to participate in the common plan;

2. for nonhighly compensated employees, employee contributions (both before-tax and after-tax) do not exceed a reasonable limitation, expressed as a dollar limit or as a percentage of compensation; the limitation would be indexed to reflect increases in the cost of health care; and

3. the employee bears no more than a specified percentage of the total cost of the common plan (taking into account the cost of co-pays and deductibles.

Enactment of these safe harbors would eliminate the need for detailed testing for the majority of the SBC welfare plans as over 93% of our employees are covered by plans that meet these clearly nondiscriminatory characteristics. An employer who provides a uniform level of coverage for its employees (without regard to compensation) should not have to spend a million or more dollars to prove that it is nondiscriminatory.

The safe harbors proposed by the APPWP will cover the most obvious void in the current statute. Enactment of this safe harbor would not degrade in any way the goals of Section 89. SBC urges your consideration and support for these safe harbors.

Preliminary proposals for Technical Corrections contain revisions that greatly simplify the testing requirement for plans that do not qualify for the two safe harbors herein presented. These include proposed changes to the statutory Definition of a Plan, the Headquarters Rule, Time of Testing, the Comparability Rule, etc.

The language in these areas of the current statute is narrow and creates unnecessary complexity. In each of the areas mentioned above, the language and testing procedures can be simplified without jeopardizing the ability of the test to identify clearly discriminatory plans. Emphasis should be given to replacing the detailed tests in the current statute with broad guidelines that preserve the intent of the nondiscrimination provisions without creating exorbitant overhead and other administrative expense.

In addition, SBC would like the following proposals considered during Technical Corrections.

- Exemption from Testing
  Plans should be exempt from nondiscrimination procedures when the cost of the plan coverage is already being imputed to the participant as taxable income.

- Multiemployer Plans
  Release employers from any responsibility for nondiscrimination testing of multiemployer plans. Consistent with the terms negotiated in collective bargaining, employers contribute an agreed upon amount, on behalf of each employee, to the plan. The type and conditions of coverage are not within the control of the employer.

Much attention has been given to the problem of data collection needed for Section 89. The complexity is multiplied for data collection on former employees. This area is especially troubling as much of the information needed is not available (marital and dependent status). The accuracy of what is available is questionable. This is an area that requires careful and unhurried deliberation. A delay in the effective date for former employees must be granted. Your support in this matter is urgently needed.

SECTION 89 DATA REQUIREMENTS

PLAN PARTICIPANT

- H C E INDICATOR
- COMPANY INDICATOR
- ACTIVE RETIRED STATUS
- PART TIME STATUS
- AGE
- DATE OF HIRE
- NON RESIDENT ALIEN INDICATOR
- MANAGEMENT INDICATOR (MANAGEMENT, NONMANAGEMENT BARGAINED, NONMANAGEMENT NONBARGAINED EMPLOYEE).

- MARITAL STATUS
- MEDICARE INDICATOR
- COBRA INFORMATION
- COORDINATION OF BENEFITS (COB) INFO
- COB COVERAGE EFFECTIVE DATE
- TYPE OF COVERAGE FOR DENTAL
- DENTAL WAIVER INDICATOR
- DATE OF RETIREMENT/TERMINATION
- EMPLOYEE COVERAGE ELECTIONS
- EMPLOYEE CONTRIBUTIONS

DEPENDENT

- DEPENDENT INDICATOR (CLASS I, CLASS II, SPONSORED CHILD, STUDENT, HANDICAP)

- COORDINATION OF BENEFITS (COB)
- COVERAGE START DATE
- COVERAGE TERMINATION DATE
- GRANDFATHERED CLASS II
- MEDICARE ELIGIBLE INDICATOR
- EMPLOYEE CONTRIBUTIONS
- COBRA INFORMATION

THIS INFORMATION IS NEEDED FOR EACH OF THE 67,000 EMPLOYEES AND THE 26,000 RETIREES.

EXHIBIT 2

SBC BENEFIT STRUCTURE - MEDICAL

EMPLOYEE/RETIREE SELECTS
BASIC PROVIDER OPTION

- CUSTOMCARE NETWORK AREA
- CUSTOMCARE OUT OF NETWORK AREA
- HMO (49)

AND

IS ELIGIBLE FOR ONE OF
THE FOLLOWING LEVELS OF COVERAGE

NON-MEDICARE ELIGIBLE:

- EMPLOYEE
- EMPLOYEE + DEPENDENT
- EMPLOYEE + 2 OR MORE DEPENDENTS
- SPONSORED DEPENDENT
- CLASS II DEPENDENT

MEDICARE ELIGIBLE:

- EMPLOYEE
- EMPLOYEE + DEPENDENT
- EMPLOYEE + 2 OR MORE DEPENDENTS
- SPONSORED DEPENDENT
- CLASS II DEPENDENT

COMBO OF MEDICARE AND NON-MEDICARE ELIGIBLE:

- EMPLOYEE + DEPENDENT
- EMPLOYEE + 2 OR MORE DEPENDENTS

SOUTHWIRE
Carrollton, Georgia 30119 • 404/832-4242

July 29, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

After reviewing the various reports and announcements on the subject of Section 89 (non-discrimination compliance) for Group Benefit Plans, it is our opinion that this type of lesiglation is counter-productive to our goal of providing the very best health and life insurance coverage to our employees.

The cost in terms of manpower and resources to design systems, gather data, and run the various tests will far outweigh the benefit of determining the fairness of benefit plans to all groups of employees.

As a matter of fact, the legislation is likely to have a reverse effect from the goals it intends to accomplish. We will likely consider reducing coverage options, eliminate certain supplemental plans and/or allow employees to pay the penalties for non-compliance.

We fully support Congress' goal of discouraging discrimination in employer provided health and group term life benefits, however Section 89 has transformed this goal into a complex web of administrative requirements exceeding the capabilities of most employers. We solicit your support in helping to simplify Section 89 and in obtaining adequate lead time to implement whatever new rules are adopted.

Sincerely,

SOUTHWIRE COMPANY

Gary L. Aldridge
Corporate Benefits Manager

"SOUTHWIRE MEANS SERVICE"

2713 Sierra Vista
Grand Junction, Colorado 81503
August 4, 1988

Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable but the resultant Section 89 non-discrimination rules are overwheling. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as they may be require under state and federal law. Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, are staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at lease a year after Treasury issues final regulations;
- Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and plight of plan sponsors is appreciated.

Sincerely yours,

Linda G Spencer

Linda G. Spencer
President, Western Colorado
Personnel Association
A Chapter of ASPA

Kessler Campus
1614 E Kessler Blvd
Longview WA 98632

ST. JOHN'S MEDICAL CENTER

Broadway Campus
600 Broadway
Longview, WA 98632

July 20, 1988

Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D. C. 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers such as us who offer both a traditional health plan and a Health Maintenance Organization.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex--yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can we be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards--you should consider the following alternatives:

- o Repealing Section 89;
- o Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
- o Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Beverly C. Lincoln, Director
Personnel Services

BCL:db

SULLIVAN & CROMWELL

July 20, 1988

Treatment of Forward Currency Contracts
Under Section 851(b)(4) of the Code
(Section 851(b)(4) and (g)(1) of the Code;
Sections 106(l)-106(o) of the Technical
Corrections Bill of 1988 (S. 2238))

This memorandum discusses the treatment under the diversification requirements of Section 851(b)(4) of the Internal Revenue Code of 1986 (the "Code") of forward currency contracts entered into by a regulated investment company ("RIC") to hedge, either partially or fully, the currency risk associated with the RIC's foreign currency denominated investments.

As discussed more fully below, we propose that in the case of a "designated hedge" under Section 851(g)(2) of the Code consisting of a forward currency contract and foreign currency denominated investments held by a RIC, the netting rule of Section 851(g)(1) of the Code apply in determining the value of the positions of the designated hedge for purposes of Section 851(b)(4) of the Code.

Discussion

Section 851(b)(4) of the Code generally requires that a RIC liversify its assets so that at the close of each quarter of the taxable year at least 50% of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other RICs and other securities. For this purpose, "other securities" of a particular issuer will be counted only if their value does not exceed 5% of the RIC's total assets and 10% of the outstanding voting securities of the issuer. In addition, a RIC may not invest more than 25% of its total assets in the securities of any one issuer (other than Government securities or securities of other RICs).

Section 851(c)(5) of the Code provides that for purposes of Section 851(b)(4) of the Code terms not otherwise defined in Section 851(c) of the Code have the same meaning as when used in the Investment Company Act of 1940, as amended. A no-action letter issued by the Securities and Exchange Commission indicates that forward currency contracts are "securities" under the Investment Company Act of 1940.* Thus, a forward currency contract may be treated as a "security" for purposes of Section 851(b)(4) of the Code, and as a consequence a RIC's position in a forward currency contract would be subject to the 5%, 10% and 25% limitations under Section 851(b)(4).

Regardless of who is considered the issuer of a forward currency contract,* or the method for determining its value*, fluctuations in foreign currency exchange rates could cause a RIC to violate the diversification requirement of Section 851(b)(4) of the Code, or could severely limit its ability to hedge its foreign currency denominated investments.* Because foreign currency exchange rates are more volatile than interest rates, this problem is more acute in the case of forward currency contracts than in the case of interest rates futures contracts and other investments the value of which is tied to interests rates.

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* Currency Fund (SEC, Sept. 25, 1986) (holding that the Securities and Exchange Commission was "unable to concur" with the applicant's view that a forward currency contract is not a security for purposes of the Investment Company Act of 1940). See also Steve Stein (SEC, Jan. 4, 1974) (indicating that a foreign currency futures contract may constitute a security).

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* There is currently no authority as to who the issuer of a forward currency contract is for purposes of Section 851(b)(4) of the Code. In determining who the issuer is of an interest rate futures contract, the Internal Revenue Service has consistently taken the position that the issuer is the issuer of the underlying security, on the theory that the issuer of the futures contract should be "the entity the economic fortunes of which ultimately determine the performance of the contract and since that is the entity in which the purchaser of such a contract invests." *See* G.C.M. 39526 (July 8, 1986) (stating the general rule set forth above and addressing the treatment of municipal bond index futures contracts). *See also* G.C.M. 39316 (Dec. 21, 1984) (stating the general rule set forth above and addressing the treatment of stock index instruments); Letter Rulings 8823067 (Mar. 11, 1988); 8726017 (Mar. 26, 1987); 8721042 (Feb. 19, 1987). Thus, under this approach the issuer of a forward currency contract would be the foreign government of the currency involved or a notional issuer which is the currency itself.

** It is unclear how a forward currency contract should be valued in applying the diversification requirements of Section 851(b)(4). Section 851(c)(4) provides that for purposes of Section 851(b)(4) of the Code the term "value" means: "with respect to securities . . . for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the board of directors . . ." With respect to interest rate futures contracts, the Internal Revenue Service has taken the position that the value is the value of the futures contract, rather than the amount paid on margin, because the investor's liability is virtually unlimited and is related to the value of the futures contract. *See* G.C.M. 39316 (Dec. 21, 1984); Letter Ruling 8823067 (Mar. 11, 1988).

To minimize the risk that a RIC would be disqualified by reason of foreign currency hedging activities, we propose that, in the case of a "designated hedge" under Section 851(g)(2) of the Code consisting of a forward currency contract and foreign currency denominated investments held by a RIC, the netting rule of Section 851(g)(1) of the Code, which now applies for purposes of the short short rule of Section 851(b)(3), also apply in determining the value of the positions of the designated hedge for purposes of Section 851(b)(4) of the Code. For example, if the value of a forward currency contract increased by reason of currency exchange rate fluctuations and the value of hedged foreign currency denominated instruments held by the RIC correspondingly decreased in value, the increase and decrease in value would be netted for purposes of applying Section 851(b)(4) of the Code to the forward currency contract and the hedged instruments.* This could be accomplished by amending Section 851(g)(1) of the Code to read as follows:

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* Section 851(d) of the Code provides that a RIC will not be disqualified by reason of violating the diversification requirement as of the end of any quarter unless the violation exists immediately after the acquisition of any security or other acquisition, and that a RIC violating the diversification requirement by reason of such an acquisition is allowed 30 days after the end of the quarter to correct the violation. Notwithstanding these provisions, fluctuations in foreign currency exchanges rates could severely limit a RIC's ability to enter into forward currency contracts.

> "(1) IN GENERAL.--In the case of any designated hedge, for purposes of subsections (b)(3) and (b)(4), increases (and decreases) during the period of the hedge in the value of positions which are part of such hedge shall be netted." (Underlined language is the new amendment).

Our complete proposal, with suggested committee report explanations, is attached to this memorandum as Annex A.

The regulations contemplated by Section 851(g)(2)(A)(iii) of the Code should clarify that a RIC's position in a foreign currency option, futures or forward contract and its investment in foreign currency denominated investments may constitute a "designated hedge". Although clause (A)(i) of Section 851(g)(2) provides that a designated hedge may exist where a RIC has an option to sell, is under a contractual obligation to sell, or has made and not closed a short sale of substantially identical property, it is unclear under current law whether a RIC writing or acquiring a foreign currency option or entering into a foreign currency futures or forward contract owns "substantially identical" property by reason of holding a foreign currency denominated stock or security. The existing authorities construing the term "substantially identical," as used in Sections 1091 and 1233 of the Code and as such term relates to foreign currency, antedate the enactment of the straddle rules and the passage of Section 988 of the Code. See e.g., Rev. Rul. 74-218, 1974-1 C.B. 202 (foreign currency not a security subject to Section 1091 of the Code); Reg. § 1.1233-1(d)(2)(i) (futures contracts in any commodity on or subject to rules of exchange not substantially identical to future requiring delivery in another calendar month). A foreign currency denominated debt security, however, clearly constitutes a position with respect to the foreign currency in which the debt is denominated for purposes of Section 1092 of the Code. Moreover, Section 988(a)(1)(A) of the Code explicitly requires separate computation of the gain or loss attributable to foreign currency fluctuations.

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* The proposed netting rule would be consistent with the position adopted by the Internal Revenue Service where a RIC enters a short (selling) position in an interest rate futures contract to hedge the value of a security owned by the RIC. In that case, the security only (and not the futures contract) is counted in applying the diversification requirement. *See* Letter Ruling 8823067 (Mar. 11, 1988). *See also* G.C.M. 39316 (Dec. 21, 1984) (stating that: "In certain hedging and risk-covered situations the securities need only be counted once. For example, if a taxpayer writes a call option or enters a short (selling) position in a futures contract and owns the identical security to 'cover' the option or futures contract, the risk is limited and the security should only be counted once in applying the diversification rules.")

Accordingly, the attached proposal should be adopted by the Committee.

Randall K.C. Kau
Sharp Sorensen
Kenneth Gershenfeld

Sullivan & Cromwell
125 Broad Street
New York, N.Y. 10004
(212) 558-4000

ANNEX A

Proposal

1. Section 851(g)(1) of the Internal Revenue Code is amended to read as follows:

> "(1) IN GENERAL. -- In the case of any designated hedge, for purposes of subsections (b)(3) and (b)(4), increases (and decreases) during the period of the hedge in the value of positions which are part of such hedge shall be netted." (Underlined language is the new amendment).

2. If the above proposal is adopted, in subsequent committee reports or explanations of the Technical Corrections Act of 1988 the following explanatory language should be added to the current language on pages 75-78 of the Description of the Technical Corrections Act of 1988 (H.R. 4333 and S.2238) prepared by the Staff of the Joint Committee on Taxation (JCS-10-88):

a. Add the following after the penultimate sentence of the first paragraph under "Definition of regulated investment company", in the "Present Law" section (page 75):

> For purposes of the 30% test, any increase in value on a position that is part of a designated hedge is offset by any decrease in value (whether or not realized) on any other position that is part of such hedge. Finally, at the close of each quarter of the RIC's taxable year at least 50% of

the value of the assets of the RIC must be represented by cash and cash items, Government securities, securities of other RICs and other securities, with such "other securities" of an issuer counted only if their value does not exceed 5% of the RIC's assets or 10% of the outstanding voting securities of the issuer. Furthermore, not more than 25% of the RIC's assets may be invested in the securities of any one issuer (other than Government securities or securities of other RICs) (the "diversification tests").

b. Add the following after the "Present Law" section (page 76):

Reasons for Change

Hedging activities

Congress recognizes that a RIC may properly engage in certain hedging activities that are consistent with the passive nature of the RIC and, under current law, in the case of certain hedging transactions both the hedged and the hedging positions are considered to be a single investment for purposes of applying the 30% test (section 851(g)). Circumstances may exist, however, in which these hedging transactions would cause a RIC to lose its qualification as such because of a failure to meet the diversification tests. Therefore, to facilitate a RIC's ability to engage in hedging activities without the risk of disqualification as a RIC, Congress believes that, in the case of a designated hedge under section 851(g), the netting rule of that section should also apply for purposes of determining the value of the positions of the hedge for purposes of applying the diversification tests.

c. Add the following to the end of "Explanations of Provisions" section (page 78):

Hedging activities

The bill provides that in the case of a designated hedge under section 851(g), the netting rule of that section will apply in determining the value of the positions of the hedge for purposes of applying the diversification tests. Therefore, for purposes of applying the diversification tests, any increase in value on a position that is part of a designated hedge is offset by any decrease in value (whether or not realized) on any other position that is part of the same hedge. The rules of section 851(g) will be applied for this purpose in the same manner as the rules of section 851(g) are applied for purposes of the 30 percent test.

Clause (A)(iii) of section 851(g)(2) authorizes the Secretary to prescribe regulations identifying positions which will qualify as positions in a designated hedge under section 851(g). These regulations shall provide that a RIC's investment in an option to sell a currency, or its short position in a currency futures contract or forward currency contract, and the RIC's investment in foreign currency denominated stocks or securities, may constitute a designated hedge for purposes of section 851(g). Prior to the issuance of such regulations, Congress intends that a RIC shall be allowed to treat such investments and positions as part of a designated hedge for purposes of section 851(g) provided the other requirements of that section are satisfied.

TALMANHOME

The Talman Home Federal Savings and Loan Association of Illinois

THOMAS J. PROST
Senior Vice President
Group Executive, Administrative Services

July 18, 1988

Senate Finance Committee
Washington, D.C.

Re: **Comments for the Record of the Senate Finance Committee hearing for technical corrections to Section 89 held July 13, 1988**.

Dear Committee Members,

I am writing to add Talman's name to the list of employers seeking relief from the burden of Section 89 of the Tax Reform Act of 1986.

We have done preliminary testing and find that compliance will require extensive investment of time and money for data gathering, analysis, plan analysis and redesign implementation. Compliance is made very difficult by the seventeen and one-half hour rule which requires the inclusion of part-time employees for testing purposes. This severely impacts the service industry which relies heavily on part-time employees for evening and weekend hours.

While the intent of section 89 may be to provide equitable benefits for all levels of employees, in fact, **it serves as a disincentive to employers to enhance employee benefits and, for that matter, to offer these plans at all.**

Therefore, we respectfully submit two requests to the committee: for simplification of the testing rules and for an extension of the compliance deadline.

Sincerely,

cc: The Honorable Alan J. Dixon, Senator
The Honorable Paul Simon, Senator
The Honorable Robert M. Terzich, 48th District Representative

Statement of The Tax Council
on The Technical Corrections Act of 1988

The Tax Council appreciates the opportunity to submit its views on the Technical Corrections Act of 1988 and issues added to it by the House Ways and Means Committee. The Council is a business supported organization concerned with Federal tax policy matters. While deliberately small in overall number, the Council represents a broad spectrum of industry including manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, public accounting, banking and other financial services.

Technical corrections to the Tax Reform Act of 1986 are necessary and overdue for taxpayer compliance. Important for capital formation and productivity are the associated extensions of the R&E credit and a settlement of the allocation of R&E expenditures between foreign and domestic sources.

Unfortunately, the House Ways and Means Committee tentatively has decided to finance the extension of provisions and certain other revenue losing provisions primarily through new tax burdens on the business sector. Not including the Alaska Native Corporations provision, the Ways and Means Committee would raise business taxes by almost $5 billion over a three year period through accelerated corporate tax payments, repeal of the completed contract method of tax accounting and a further cutback in the dividend received deduction. There would be tax relief for the business sector in provision extensions, but the three year total would amount to an estimated $3.1 billion, far less than the new tax burden on business. Furthermore, to reduce the overall revenue cost of the extensions the Ways and Means Committee generally would make them effective only through 1990 and would cut back some benefit. The R&E credit for example, would be at risk again in only two years and would involve a basis adjustment for the amount of credit taken. Its incentive value would be reduced accordingly. In contrast, the two largest revenue raisers from the corporate sector would be permanent tax increases.

The Ways and Means Committee action to raise business taxes comes on top of several tax measures where business also has borne the brunt. In fact, according to the FY 1989 budget proposal, the net effect of major enacted legislation from 1981 through 1987 -- including the Economic Recovery Tax Act of 1981, the Tax

Reform Act of 1986, and the 1987 Reconciliation Act -- was a large increase in corporate tax liabilities estimated at $160 billion for the 1987-1991 period. For the same period, individual taxpayers will experience very substantial net tax reduction on the order of $1.2 trillion. To continue to utilize the corporate income tax as a means of achieving a "quick fix" of the budget deficit problem is short-sighted and could result in a permanent disincentive to long-term economic growth.

For tax policy, the Ways and Means Committee proposal to lower again the dividend received deduction for corporate portfolio investments is particularly troubling. Under the Committee bill, the deduction for dividends received from corporate stock ownership of less than 20 percent in other corporations would fall from 70 percent to 50 percent by 1991. This would aggravate the 1987 Act provision and double taxation of corporate earnings. In fact, it really constitutes triple taxation when the portion of dividend income subject to the tax penalty is distributed to shareholders. There is absolutely no policy justification for this provision. If enacted it would encourage corporations to rely even more on debt financing, as opposed to equity financing, and would increase the risks of economic destabilization. Furthermore, the significant economic issues involved in multiple taxation of corporate earnings hardly should be considered in the context of a narrow technical corrections bill.

The Tax Council urges the Senate Finance Committee to approve expeditiously the technical corrections necessary for tax policy guidance on the Tax Reform Act of 1986. The Council also urges adoption of important provision extensions, particularly the R&E credit and allocation of R&E expenditures. For maximum encouragement of productive research, the R&E credit should be made permanent without a basis adjustment.

The anti-investment provisions of the House Ways and Means Committee bill, especially the proposed dividend deduction cutback and the repeal of the completed contract method, should be dropped. Any shortfall from the extension of provisions could be made up by broadening hospital insurance payroll tax coverage as proposed earlier by the Administration.

TTC

July 27, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Bldg.
Washington, DC 20510

Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
SH-203, Hart Senate Office Bldg.
Washington, DC 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical
Corrections IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternative coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

THE TERTELING COMPANY, INC. / 1755 WESTGATE DRIVE / P.O. BOX 4127 / BOISE, IDAHO 83704

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are not in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89
- Delaying Section 89's effective data to a least a year after Treasury issues final regulations
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Very truly yours,

THE TERTELING COMPANY, INC.

Bobbi Aspitarte
Executive Assistant

BJA/em

TRUITT
BROS.,
INC.

1105 FRONT ST. N.E., SALEM, ORE. 97308 P.O. BOX 309/PH. (503) 362-3674
TWX: 510-599-0102

July 19, 1988

Ms. Laura Wilcox, Hearing Administrator
US Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

Several years ago, we made rather significant changes in the benefit programs at our Company, putting all our year-round people...hourly, salaried, and owners of the Company...under the same health, life, and accident insurance programs. My primary motivation for doing this was to have a good, generous program available in which our year-round employees, from top to bottom, were treated equally.

Now, I learn that under the Tax Reform Act of 1986 we're about to get clobbered. I'm referring to the requirement that health insurance plans not discriminate in favor of highly compensated employees. There is no problem when comparing any salaried person with year-round hourly positions. A problem arises, however, when nondiscrimination tests are applied to our seasonal people versus the highly compensated employees.

Although we're not required to do so, we provide a very good major medical health insurance plan for our seasonal people who have worked with us for three years. Not all food processing companies do this. However, this apparently isn't good enough; and this legislation is going to force us to do one of the following:

- Eliminate health coverage for all seasonal employees, or

- Increase the health insurance benefits for all seasonal employees, or

- Require our highly compensated people to pay taxes on a portion of the benefits that they've been getting for a number of years.

- The most onerous thing it will force us to do, though, is to identify and collect all this data and apply it to a series of nondiscrimination tests. It's not very clear how to do it, and it appears that our small Company will have to hire another individual just to accomplish all this.

I have no quarrel with the desire to promote more nearly equal benefit levels in industry - in fact, that's just what we did a number of years ago. In the seasonal Fruit and Vegetable Processing Industry, however, there are different levels of pay and benefits for the seasonal workers. There's no question that they are an important part of our operation; but they're with us for periods of a couple of weeks to perhaps four months, hence the differences in benefits.

I believe you have created a piece of complex, difficult, and, ultimately, expensive (to us) legislation to go after what was probably a noble objective. I just wish you could figure out a simpler way to accomplish all this.

Very truly yours,

David J. Truitt
David J. Truitt

DJT:mm

Tuality Community Hospital

TUALITY

July 25, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205 Dirksen Senate Office Building
Washington D.C. 20510

Re: Comments for the Record, July 13, 1988
Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the IRC, added by the Tax Reform Act of 1986, adds a great bit of burden to Plan sponsors such as our company. Most of the data is very difficult to obtain and will not be used for any purpose, therefore, leading to a great expense when we are already finding the cost of healthcare quite high for our employees.

Is it really necessary to use such a complicated and detailed method to prove non-discrimination, especially for those of us that have never discriminated in the past, but are in the position where we will have to provide non-discrimination according to nearly incomprehensible standards? While there is an alternative coverage test, it does not apply to our corporation, as well as many others as we offer both traditional healthcare and an HMO.

Is it fair to penalize employers who wish to provide employees with a choice of benefits? We find that the rules are incredibly complex and yet we are still lacking necessary treasury regulations. Even if regulations are issued in the near future, we will not have adequate time to respond to the new requirements before the deadline date.

We appeal to you to reconsider Section 89 by reviewing the following alternatives:

1. Repealing Section 89
2. Delaying Section 89's effective date for a period of time to allow regulations to assist employers in reviewing data.
3. Simplify the rules by establishing more simplified non-discrimination tests.

Thank you for your consideration of this letter as we, too, as a healthcare corporation seek to reduce the cost of healthcare.

Sincerely,

Daryl L. Gohl
Director of Human Resources

UNITED GROCERS, INC.

HEADQUARTERS
6433 S.E. Lake Road P.O. Box 22187
Portland, Oregon 97222-0082 503/653-6330
Telecopier (503) 652-7358

MEDFORD DIVISION
2195 Sage Road P.O. Box 1647
Medford, Oregon 97501-0126 503/773-7383

July 21, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments for the record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox,

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are encredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- * Repealing Section 89;
- * Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
- * Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Alan Jones
President

CC/ Ed Mihalski
Mark Hatfield
Bob Packwood
Les Aucoin
Robert F. Smith
Ron Wyden
Peter DeFazio
Denny Smith

jm/1190A

UNITED STATES FIDELITY AND GUARANTY COMPANY
P. O. BOX 1138
BALTIMORE, MARYLAND 21203
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HUMAN RESOURCES DEPARTMENT

July 26, 1988

Ms. Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Re: IRC Section 89

Dear Ms. Wilcox:

As an Employee Benefits Manager, I am greatly concerned about the review by your Committee regarding the technical corrections legislation (S. 2239), including possible revisions to Section 89.

I, therefore, ask your assistance in simplifying Section 89 which has already cost us in money and resources in attempting to understand what will be required to gather the data and to design and implement systems to run the tests.

To-date, we have determined that it will be necessary to perform a total of 378 tests. Obviously, this will be time consuming and costly.

I think you and your Committee should be aware of the possible negative health policy implications Section 89 can cause. It may compel sponsors to reduce options, eliminate employer subsidies or otherwise sumplify their benefit packages to make testing easier.

Obvisously, employers are still in the dark as to how to value the benefit to be tested. I implore you to give employers significant lead time to implement Section 89 once the final regulations are published.

Please include the above comments as being for the record of the hearing on Technical Corrections held July 13, 1988.

Thank you for your support on this matter.

Sincerely,

Mary Carole Kirkpatrick
Superintendent

1212 Avenue of the Americas New York, New York 10036
Telephone: 212 354 4480 Telex: USCOUNCIL 14-8361 NYK

United States Council for International Business

Serving American Business as U.S. Affiliate of:

The International Chamber of Commerce
The International Organisation of Employers
The Business and Industry Advisory Committee to the OECD
The ATA Carnet System

July 21, 1988

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
205 Senate Dirksen Office Building
Washington, D.C. 20510-6200

RE: Technical Corrections Act of 1988 -- H.R. 4333 Section 112(aa)

Dear Mr. Chairman:

In response to your request for comments on the Technical Corrections Act of 1988 (H.R. 4333), I respectfully submit the following on behalf of the United States Council for International Business.

The U.S. Council for International Business is comprised of some 300 major corporations, law firms, and accounting firms with substantial experience in foreign operations of U.S. entities. The Council represents American business in the major international economic institutions such as the OECD and the International Chamber of Commerce. Its primary objective is to promote an open system of world trade, finance, and investment.

The U.S. Council wishes to express its concern over Section 112(aa), a provision that would result in an override of international tax treaty obligations of the United States. This provision in the "technical corrections" legislation is hardly a technical correction. In fact, it represents a reversal of the long-standing U.S. treaty policy of honoring all treaty commitments unless subsequent legislation clearly evidences an intention to override one or more specific treaty provisions. Under the pending legislation, unless the 1986 Tax Reform Act expressly provides that an existing income tax treaty provision is to prevail over any inconsistent rule adopted in the 1986 Act, the provisions of the 1986 Tax Act will apply in the case of any known or future, and as yet unknown, conflict between the Act and any treaty provision in effect on date of enactment of the 1986 Tax Act. There are some 38 treaties in effect subject to this treaty override rule. This new rule also establishes a new treaty override policy for future legislation.

We consider this provision most unfortunate--a significant step backward in the implementation of the extensive treaty program to which the U.S. has been faithfully committed for many years. Treaties, after all, do not instantaneously materialize; they are concluded after lengthy and careful negotiations between the two countries to accommodate to each other's tax systems in the interest of encouraging bilateral trade, commerce and investment. Moreover, treaties so spawned require long-term nurturing, together with mutual respect and reliance by treaty the partners. Treaty partners should be able to rely upon their treaties until such treaties are revised through renegotiation. Wholesale overrides and cavalier disregard of our international commitments, as has been clearly demonstrated in the 1986 Act, and now again in the Technical Corrections thereto, do discredit to the leadership role which the U.S. has traditionally sought to exercise, and does injustice to our treaty partners.

Although technically correct, it is wrong to argue, narrowly, that, since the constitutional authority in support of treaty overrides exists, it is therefore justified. We oppose any and all tax legislative treaty overrides. We are in agreement with the U.S. Treasury Department's view in believing that a bilateral negotiation (or termination) is the appropriate vehicle for changing treaties. Even assuming arguendo that selective treaty overrides aimed at specific abuses are appropriate (which we do not believe is the proper approach), surely a residual treaty override to negate any potential conflict that is not as yet apparent is patently contrary to the bilateral protective and mutual reliance principles underlying out treaty negotiation process.

This is such an extraordinarily important matter of principle, impinging upon international comity, that, at the very least, it should not be relegated to resolution as a "technical correction."

Sincerely,

RMHammer

Richard M. Hammer
Chairman
U.S. Council Committee on
Taxation

United States Department of the Interior
OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

September 21, 1983

Memorandum

To: Assistant Secretary--Indian Affairs

From: Solicitor William H. Coldiron

Subject: Federal income taxation of Stevens treaty fishing income

You have asked my opinion as to whether the income of members of certain Washington State treaty tribes generated from commercial fishing pursuant to the treaties is subject to the federal income tax. It is my opinion that fishermen who are members of tribes that have established treaty rights 1/ are exempt from federal income tax on fishing income earned pursuant to those treaties. This opinion does not apply to income earned by these same fishermen from other sources, such as fishing in nontreaty areas or to income derived from fish in excess of 50% of the available take. This opinion applies only to the federal income tax and does not apply to any other federal tax, excise, fee or license of any kind whatsoever. This opinion does not apply to State taxation in any form.

Your request for my opinion was, I understand, prompted by recent enforcement efforts of the Internal Revenue Service directed toward members of the Lummi, Tulalip, Puyallup and Swinomish Tribes 2/ and seeking to collect taxes on treaty

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1/ *United States v. Washington* 384 F.Supp. 312 (W.D. Wash. 1974), *aff'd* 520 F.2d 676 (9th Cir. 1975) *cert. denied*, 423 U.S. 1086 (1976); *United States v. Washington*, 459 F.Supp. 1020 (W.D. Wash. 1978); *Puget Sound Gillnetters Ass'n v. U.S. District Court*, 573 F.2d 1123 (9th Cir. 1978); *Washington v. Wash. State Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658 (1979).

2/ In addition to these tribes, other tribes with treaty rights in Washington include the Hoh, Makah, Muckleshoot, Nisqually, Quileute, Quinault, Sauk-Suiattle, Skokomish, Squaxin Island, Stillaguamish, Upper Skagit, Nooksack, Suquamish, Port Gamble Band of Clallam Indians, Lower Elwha Tribal Community, Jamestown Band of Clallam Indians and the Yakima Indian Nation. A number of Oregon and Idaho Indian tribes have similar treaty fishing rights.

fishing income. The Internal Revenue Service, of course, has responsibility for the interpretation and enforcement of the federal income tax laws. However, this Department has the primary responsibility within the federal government for the protection of Indian treaty fishing rights, including the authority and responsibility to interpret those rights. Accordingly, I believe it is not only appropriate but necessary that I interpret the treaties in this instance, where the interpretation of the federal tax laws under which the IRS is proceeding may conflict with fishing rights guaranteed under the treaties.

At the outset, I recognize that the only two decided cases on this issue have found that treaty fishing income is subject to the federal income tax. Strom v. Commissioner, 6 T.C. 621 (1946), aff'd per curiam, 158 F.2d 520 (9th Cir. 1947); Earl v. Commissioner, 78 T.C. 1014 (1982). However, as more fully discussed below, both decisions suffer from a lack of adequate consideration of the treaty rights involved. The Strom case was decided prior to both the United States v. Washington series of cases, which comprehensively interpreted the treaty fishing rights for the first time, and the Supreme Court's decision in Squire v. Capoeman, 351 U.S. 1 (1956), now the controlling case on questions of federal taxation of Indian trust and treaty income. The Earl case was brought pro se by an individual Indian fisherman, who never presented the court with the appropriate arguments on his own behalf. I do not believe therefore that these cases may be considered dispositive of the issue.

The Treaties

The treaties relevant to this issue are the six treaties negotiated by Governor Stevens in the 1850's with tribes in Washington State. 3/ Governor Stevens negotiated these treaties in order to clear title to the lands then in the Territory of Washington. The tribes and bands in Washington ceded title to vast areas of land in exchange for small reservations and various other guarantees. With immaterial variations, the treaties each provide:

3/ Treaty of Medicine Creek, December 26, 1854, 10 Stat. 1132; Treaty of Point Elliott, January 22, 1855, 12 Stat. 927; Treaty of Point No Point, January 26, 1855, 12 Stat. 933; Treaty of Neah Bay, January 31, 1855, 12 Stat. 939; Treaty with the Yakimas, June 9, 1855, 12 Stat. 951; Treaty of Olympia, July 1, 1855 and January 25, 1856, 12 Stat. 971.

> The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians, in common with all citizens of the United States; and of erecting temporary houses for the purpose of curing; . . .

Article 4, Treaty of Point No Point, 12 Stat. 933.

This reservation of a right to fish has been interpreted seven times by the United States Supreme Court. United States v. Winans, 198 U.S. 371 (1905); Seufert Bros. Co. v. United States, 249 U.S. 194 (1919); Tulee v. Washington, 315 U.S. 681 (1942); Puyallup Tribe v. Department of Game (Puyallup I), 391 U.S. 392 (1968); Department of Game v. Puyallup Tribe (Puyallup II), 414 U.S. 44 (1973); Puyallup Tribe v. Department of Game (Puyallup III), 433 U.S. 165 (1977); Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel), 443 U.S. 658 (1979). These decisions establish the treaty right of the Indians to fish at their usual and accustomed places free of state regulation except where necessary for purposes of conservation and their right to take up to 50% of the available fish.

The fishing rights reserved by the Indians in the treaties included not only the right to fish for subsistence purposes but the right to fish for commercial purposes. At the time of the treaties, the Indians fished commercially, as recognized by the Supreme Court: "Fish constituted a major part of the Indian diet, was used for commercial purposes and indeed was traded in substantial volume." Fishing Vessel, supra, 443 U.S. at 665. Quoting from the district court's opinion, the Court described the Indians' reliance on fish for commercial purposes in more detail:

> "At the time of the treaties, trade was carried on among the Indian groups throughout a wide geographic area. Fish was a basic element of the trade. There is some evidence that the volume of this intra-tribal trade was substantial, but it is not possible to compare it with the volume of present-day commercial trading in salmon. Such trading was, however, important to the Indians at the time of the treaties. In addition to potlatching, which is a system of exchange between communities in a social context often typified by competitive

> gifting, there was a considerable amount of outright sale and trade beyond the local community and sometimes over great distances. In the decade immediately preceding the treaties, Indian fishing increased in order to accommodate increased demand for local non-Indian consumption and for export, as well as to provide money for purchase of introduced commodities and to obtain substitute non-Indian goods for native products which were no longer available because of the non-Indian movement into the area. Those involved in negotiating the treaties recognized the contribution that Indian fishermen made to the territorial economy because Indians caught most of the non-Indians' fish for them, plus clams and oysters."

443 U.S. at 665-666, n.7. The Court went on to find that, "During the [treaty] negotiations, the vital importance of the fish to the Indians was repeatedly emphasized by both sides, and [Governor Stevens'] promises that the treaties would protect that source of food and commerce was crucial in obtaining the Indians' assent." 443 U.S. at 676. The Supreme Court's conclusion that the treaty reserved to the Indians a right to take up to 50% of the available fish incorporates the Court's recognition of the role of fish in the Indians' economy and its recognition that the treaty negotiators understood that role and intended that the right to fish commercially was to be included in the rights reserved to the Indians.

Other Supreme Court decisions have held that the State of Washington could not require an Indian exercising off-reservation fishing rights to purchase a state fishing license, Tulee v. Washington, supra, and that the state's regulatory authority over treaty fishing was limited to that regulation reasonable and necessary for conservation. Tulee, Puyallup I, Puyallup II.

The United States, a direct party to the treaties, is of course bound by them and, absent exercise by Congress of its power to abrogate treaties, is subject to limitations similar to those imposed on the state with regard to the Indians' treaty rights. United States v. Winans, supra, 198 U.S. at 381-382; Hoh Indian Tribe v. Baldridge, 522 F. Supp. 683 (W.D. Wash. 1981).

The Tax Cases

In Squire v. Capoeman, 351 U.S. 1 (1956), the leading case on federal taxation of Indian income, the Supreme Court considered whether capital gains from the sale of standing timber on allotted lands was subject to the federal income tax. The Court held that the General Allotment Act of 1887, 24 Stat. 388, created an exemption from the tax in the circumstances before it. In reaching its conclusion, the Court acknowledged that the General Allotment Act did not contain an express exemption from the tax but nonetheless inferred an exemption from the government's undertaking, expressed in section 5 of the act, 25 U.S.C. §348, to convey the allotment at the end of the trust period "free of all charge or incumbrance whatsoever" and a 1906 amendment to section 6 of the act, 25 U.S.C. §349, which provides for removal of "all restrictions as to . . . taxation" after issuance of a fee patent. 351 U.S. at 6-8. The Court also found that the tax exemption was necessary to fulfill the purpose of the allotment system "to protect the Indians' interest and 'to prepare the Indians to take their place as independent, qualified members of the modern body politic.'" 351 U.S. at 9.

The Court responded thus to the government's argument that the case should be treated as an ordinary tax case:

> We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens. We also agree that, to be valid, exemptions to tax laws should be clearly expressed. But we cannot agree that taxability of respondents in these circumstances is unaffected by the treaty, the trust patent or the Allotment Act.

351 U.S. at 6.

While the Court acknowledged that a tax exemption must be clearly expressed, it found the necessary clear expression in language which, as noted above, implied, rather than expressly stated, the exemption. 351 U.S. at 6-8. It did so by reference to the intent of Congress in the General Allotment Act, 351 U.S. at 7-8, and to the principle of treaty and statutory construction which the Court described thus:

> Doubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith. Hence, in the words of Chief Justice Marshall, "The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense." [Citations omitted]

351 U.S. at 6-7. 4/

The Court in Capoeman held that the taxes from which the General Allotment Act was intended to shield allotments during the trust period included the federal income tax,

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4/ This same rule was called upon by the Supreme Court in Fishing Vessel when it discussed the necessity of interpreting the Stevens treaties in accord with the intent of the parties:

> [I]t is the intention of the parties, and not solely that of the superior side, that must control any attempt to interpret the treaties. When Indians are involved, this Court has long given special meaning to this rule. It has held that the United States, as the party with the presumptively superior negotiating skills and superior knowledge of the language in which the treaty is recorded, has a responsibility to avoid taking advantage of the other side. "[T]he treaty must therefore be construed, not according to the technical meaning of its words to learned lawyers, but in the sense in which they would naturally be understood by the Indians." This rule, in fact, has thrice been explicitly relied on by the Court in broadly interpreting these very treaties in the Indians' favor. [citations omitted]

443 U.S. at 675-676.

even though that tax was not in existence at the time the General Allotment Act and its 1906 amendment were enacted. 351 U.S. at 7-8. The Court also rejected the argument put forth by the government that taxation of income derived from an allotment was sufficiently distinct from direct taxation of the allotment to make income taxation permissible even if direct taxation were prohibited. See 351 U.S. at 6.

Lower court decisions following Capoeman have established that the tax exemption in the General Allotment Act applies as well to allotments made under other allotment acts even though those acts do not necessarily contain the exemptive language of the General Allotment Act. Big Eagle v. United States, 300 F.2d 765 (Ct.Cl. 1962); United States v. Hallam, 304 F.2d 620 (10th Cir. 1962); Stevens v. Comm'r, 452 F.2d 741 (9th Cir. 1971). The courts reasoned that the other allotment acts had the same purpose as the General Allotment Act 5/ and therefore the same tax exemption should apply. These decisions recognize the essential Capoeman holding as founded upon the purpose of the General Allotment Act rather than upon the presence of specific language.

Other lower court decisions which have addressed the extent of the General Allotment Act exemption have held that income earned by an Indian from land purchased and placed in trust for him under §5 of the Indian Reorganization Act, 25 U.S.C. §465, shares the tax exemption, Stevens v. Comm'r, supra, but that income earned by an Indian from tribal or other Indians' trust land does not. Holt v. Comm'r, 364 F.2d 38 (8th Cir. 1966), cert. denied, 386 U.S. 931; Fry v. Comm'r, 557 F.2d 646 (9th Cir. 1977), cert. denied, 434 U.S. 1011; United States v. Anderson, 625 F.2d 910 (9th Cir. 1980), cert. denied, 450 U.S. 920. The courts in these latter cases viewed the purpose of the General Allotment Act as one to protect the allottees' property from encumbrance during the trust period, a purpose which would not be infringed by taxation of an Indian's income from other than his own trust property. Thus, while holding the income at

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5/ The Court of Claims stated in Big Eagle, "Parallel congressional purposes [between the General Allotment Act and the Osage Allotment Act] are apparent, but the basic purpose is the one alluded to in Capoeman and that is to protect the property so that it will adequately serve the needs of the ward and finally bring him to a state of competency and independence. This chance is encouraged, if not guaranteed, by tax exemption." 300 F.2d at 771-772.

issue taxable, these decisions recognized the relevance of the underlying purpose of a treaty or statute to the determination whether language contained therein expresses a tax exemption applicable to the particular circumstances at issue.

The courts in Holt, Fry, and Anderson, having found the General Allotment Act exemption inapplicable, were also unable to find any exemption in other statutes or treaties relevant to the income at issue. These decisions, as well as others, 6/ demonstrate that a tax exemption must derive from language in a treaty or statute and that an exemption may not be based on policy alone or on generalized references to treaties and statutes. E.g., Anderson, supra; LaFontaine v. Comm'r, 533 F.2d 382 (8th Cir. 1976). While holding the particular income at issue taxable, these courts have followed the basic teachings of Capoeman. As the Court of Appeals for the Ninth Circuit stated in Anderson, that court's most recent opportunity to consider the issue,

> The rule that ambiguous statutes and treaties are to be construed in favor of Indians applies to tax exemptions, . . . but this rule "comes into play only if such statute or treaty contains language which can reasonably be construed to confer income [tax] exemptions" . . . "The intent to exclude must be definitely expressed, where, as here, the general language of the Act laying the tax is broad enough to include the subject-matter." (citations omitted.)

625 F.2d at 913. Further, in response to Anderson's argument that the policy of the General Allotment Act was applicable to his income earned from land other than his own (to which the court found the GAA exemption did not extend), the court stated,

> Capoeman and every other Supreme Court and Ninth Circuit case have held that such policy arguments are fruitless in the absence of statutory or treaty language that arguably is an express tax exemption. Such policy arguments, however, might persuade courts to con-

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6/ E.g., Comm'r v. Walker, 326 F.2d 261 (9th Cir. 1964) and Jourdain v. Comm'r, 617 F.2d 507 (8th Cir. 1980) cert. denied 449 U.S. 839, holding the salaries of tribal officials taxable.

> strue such arguable language, if any exists, actually to be an express tax exemption.

625 F.2d at 914, n. 6.

Analysis

Capoeman and its progeny make clear that a tax exemption must be based on treaty or statutory language, arguably creating an exemption, which is applicable to the income-producing activity at issue. Once such arguable language is identified, however, the policy or purpose of the treaty or statute may be called upon to determine whether the language does in fact create an exemption.

The language in the Stevens treaties expressly securing to the Indians the right of "taking fish at usual and accustomed grounds and stations" is such arguable language. First, it is directly applicable to the fishing activity at issue. Thus the instant situation is easily distinguishable from the taxpayers' unsuccessful attempts in Holt, Fry, and Anderson to apply the General Allotment Act tax exemption to income from land to which the General Allotment Act itself did not apply, and from attempts to infer tax exemptions from other statutory or treaty language which had no direct relation to the activity at issue. E.g., Anderson, Jourdain v. Comm'r; LaFontaine v. Comm'r. 7/

Second, the treaty provision states no limitation on the Indians' right to fish at usual and accustomed places other than that the right is to be exercised in common with citizens. On its face, the provision might well be read to prohibit any limitation on or diminishment of the fishing right other than the one specified. Of course, it might also be read

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7/ In Anderson, the Ninth Circuit rejected arguments that sections 5, 6, and 16 of the Indian Reorganization Act, 25 U.S.C. §§465, 466, 476, conferred income tax exemptions for the income of an Indian derived from other Indians' land. 625 F.2d at 915-916. In Jourdain, the Eighth Circuit concluded that a treaty provision protecting Indians from "molestation by the United States" did not preclude income taxation of a tribal official's salary. 617 F.2d at 508-509. In LaFontaine, the Eighth Circuit found that the taxpayer, while citing more than thirty treaties, was unable to point to any provision therein exempting his income from taxation. 533 F.2d at 382.

otherwise but, at the least, an ambiguity exists, sufficient to call into play the rules of construction relating to ambiguous treaty and statutory provisions. Moreover, such an ambiguity makes the language arguably a tax exemption and so requires that the purpose and policy of the treaty be examined to determine whether a tax exemption does exist.

As discussed above at pages 3-4, the right to fish under the Stevens treaties includes the right to fish commercially and thus necessarily the right to earn income from fishing. Commercial fishing under the Stevens treaties, unlike many other economic activities in which Indians might engage, is thus specifically and expressly protected from interference by the United States.

As to the understanding of the Indian treaty negotiators which, as discussed above, the Supreme Court has considered critical to the proper construction of treaties, it is no more likely that the Indians understood that the federal government would tax their fishing right than that they understood that future states would be able to impose a charge upon it. To the contrary, the Indians were assured that they would be able to fish and trade as they had prior to the treaties, see p. 4, supra, when they paid no taxes and were not required, in any other manner, to turn over a portion of their fishing catch or proceeds to the government.

Accordingly, in my view, the rules of treaty and statutory construction relied upon by the Supreme Court in Fishing Vessel, Tulee, and Capoeman require the conclusion that the Stevens treaties reserved to the Indians the right to fish free from taxation, including federal income taxation.

The question remains whether the later-enacted Internal Revenue Code abrogated or modified this treaty right, because Congress, unlike the state legislatures, has the power to abrogate treaties with Indians. Lone Wolf v. Hitchcock, 187 U.S. 553 (1903).

In Capoeman, the Supreme Court concluded that the Internal Revenue Code did not modify the federal government's undertaking in the General Allotment Act to hold allotments free of taxation in order to fulfill the purpose of that Act. 8/

8/ "It is unreasonable to infer that, in enacting the income tax law, Congress intended to limit or undermine the Government's undertaking. To tax respondent under these circumstances would . . . be 'at the least a sorry breach of faith with these Indians.'" 351 U.S. at 10.

Similarly, the Internal Revenue Code, in my view, did not modify the obligation undertaken by the federal government in the Stevens treaties to recognize the fishing rights reserved to the Indians. As the Supreme Court has stated, "While the power to abrogate [treaty] rights exists . . . 'the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress.'" (citing, inter alia, Squire v. Capoeman.) Menominee Tribe v. United States, 391 U.S. 404, 412-413 (1968). In Menominee, the Court held that a statute terminating the federal relationship with the Menominee Tribe did not abrogate the tribe's treaty hunting and fishing rights even though those rights derived from a treaty provision creating the tribe's reservation and the reservation itself was extinguished pursuant to the termination act. The Court, as it said, "decline[d] to construe the Termination Act as a backhanded way of abrogating the hunting and fishing rights of these Indians." 391 U.S. at 412. The Court reiterated the principle of Menominee in Fishing Vessel, while holding that a 1930 agreement between the United States and Canada did not implicitly extinguish the Indians' treaty right. "Absent explicit statutory language," the Court stated, "we have been extremely reluctant to find congressional abrogation of treaty rights." 443 U.S. at 690.

One court has found an implied limitation upon Indian treaty hunting and fishing rights in the Eagle Protection Act, 16 U.S.C. §§668-668d. United States v. Fryberg, 622 F.2d 1010 (9th Cir. 1980), cert. denied, 449 U.S. 1004. 9/ Although the court acknowledged the lack of express language in the Eagle Protection Act abrogating or modifying the treaty, it relied upon a body of evidence in surrounding circumstances and legislative history which it believed indicated that Congress did intend that the act apply to treaty Indians, and upon the well-established principle that reasonable and non-discriminatory conservation statutes apply to treaty rights when such application is necessary to achieve the conservation purpose of the statutes. 10/ The court also noted that the modification of the Indians' hunting rights was relatively insignificant because eagles had never provided the Indians with "any commercial benefit or . . . subsistence

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9/ The Eighth Circuit reached the opposite conclusion in United States v. White, 508 U.S. 453 (8th Cir. 1974), stating that "it was incumbent upon Congress to expressly abrogate or modify the spirit of the relationship between the United States and the Red Lake Chippewa Indians on their native reservation." Id., at 457-458.

10/ See cases cited supra at p. 4.

value." 622 F.2d at 1014. Rather, the court noted, the only apparent reason to hunt eagles was for religious and ceremonial purposes, and the act contained an exception permitting use of eagle specimens for religious purposes. Id.

The situation with respect to taxation of treaty fishing income is clearly distinguishable from that addressed in Fryberg. The treaty modification which would be implicated by application of the federal income tax to income from treaty fishing is significant because it would diminish the value of the right to fish commercially, a right which, as discussed above, was clearly reserved to the Indians by the treaties. In effect, it would represent a taking by the United States of a portion of the right it guaranteed to the Indians. Moreover, unlike the conservation measures addressed in Fryberg and the Puyallup cases, supra, at 3-4, whose effectiveness depends upon their being applicable to everyone, the federal income tax can achieve its purpose even though it does not tax every source of income. The "necessity" rationale supporting application of conservation laws to treaty rights is therefore lacking in the case of tax laws. Accordingly, under the principles of Capoeman and Menominee, absent more explicit language than is present in the Internal Revenue Code, Congress should not be deemed to have modified the Stevens treaty fishing rights nor to have limited or undermined the federal government's undertaking in those treaties.

Strom and Earl are Incorrect

As I mentioned at the outset, the only two court decisions on federal income taxation of treaty fishing income have concluded that such income is subject to tax. Strom v. Commissioner, 6 T.C. 621 (1946), aff'd per curiam, 158 F.2d 520 (9th Cir. 1947); Earl v. Commissioner, 78 T.C. 1014 (1982).

The Strom decision predated both Squire v. Capoeman and the United States v. Washington series of cases. The case involved on-reservation fishing by two members of the Quinault Tribe. The Tax Court apparently considered only Article II of the Quinault treaty, 12 Stat. 971, which authorized the setting aside of a reservation (and by implication exclusive fishing rights therein) for the Quinaults, and not the explicit language in Article III reserving off-reservation fishing rights, which is the language that, as discussed above, creates the tax exemption. 11/ In any event, the court analyzed the case by reference to two Supreme Court cases holding taxable a competent Indian's share of tribal oil and gas royalty income and an Indian's investment income. 12/

The third case relied upon by the Tax Court in Strom, an earlier Tax Court decision affirmed by the Tenth Circuit, held that an Indian's restricted land and income therefrom was subject to the federal estate tax. 13/ In light of Capoeman and subsequent decisions, this case is not presently followed by the IRS. See Rev. Rul. 69-164, 1969-1 C.B. 220.

Applying these three cases, the Tax Court made several statements in support of its conclusion which, after Capoeman and Fishing Vessel, are unpersuasive. First, the court stated that there was no express exemption from tax in the treaty. As discussed above at pp. 5-9, we now know from Capoeman and its progeny that a tax exemption, although it must derive from specific language in a treaty or statute, need not be expressly couched in terms of nontaxability. Second, the court considered it significant that the fishing income at issue was in the "untrammeled possession" of the petitioners.

11/ Although the Article III language ostensibly applies only to off-reservation fishing, the Supreme Court held in Fishing Vessel that it also applies to on-reservation fishing, to the extent, at least, that the Indians' on-reservation catch counts in their 50% allocation. 443 U.S. at 687.

12/ Choteau v. Burnet, 283 U.S. 691 (1931); Superintendent of Five Civilized Tribes v. Comm'r, 295 U.S. 418 (1935). Both cases were distinguished by the Supreme Court in Capoeman, 351 U.S. at 9 and n.19. At the time Strom was decided, the Supreme Court appeared headed toward a rule that all or essentially all Indian income was taxable, a clear change of direction from the earlier understanding, derived from administrative rulings, that no Indian income from tribal or allotted lands was taxable. It was not until ten years after Strom that the Supreme Court in Capoeman limited the scope of the Choteau and Superintendent holdings and signalled a return of the pendulum to a point between the two extremes. For an historical analysis of the tax cases, see Putzi, "Indians and Federal Income Taxation," 2 N.Mex. Law Rev. 200 (1972); Fiske and Wilson, "Federal Income Taxation of Indian Income from Restricted Lands," 10 Land and Water Law Rev. 63 (1975).

13/ Landman v. Comm'r, 42 B.T.A. 958 (1940) aff'd 123 F.2d 787 (10th Cir. 1941) cert. denied 315 U.S. 810.

Capoeman sets no requirement that income from allotments (as distinguished from the allotments themselves) must be in restricted status in order to be tax exempt. Third, although it conceded that the federal government could not directly tax exercise of the fishing right, the court concluded that the government could tax income from fishing because a tax on income was not a burden on the fishing right. As discussed above at p. 7, the same distinction between a direct tax and a tax on income was argued by the government in Capoeman and rejected by the Supreme Court. Moreover, after Fishing Vessel, it is clear that the fishing right reserved by the treaties encompassed the right to sell fish, so that an income tax is, in fact, a burden on the fishing right. See supra, at pp. 10-11. Finally, the court appears to have premised its conclusion in part upon an error of fact, in that it apparently believed that the Indians at treaty time had not engaged in substantial commercial fishing. The court stated, for instance, "It is a far cry from the fishing operations of the members of an uncivilized tribe of Indians at the time of the execution of this treaty, and the commercial fishing business now carried on by the petitioners." 6 T.C. at 627. As we now know, however, the treaty Indians did in fact rely heavily upon fish for commercial purposes. See supra at 3-4.

In my view, the law as it has developed since Strom and the facts about Indian fishing that have come to light since Strom have undermined that decision so completely that it must now be considered unsound precedent.

Earl v. Comm'r, supra, is a 1982 Tax Court decision which reached the same conclusion as Strom. For a number of reasons, I do not believe it is persuasive authority. First, the opinion reflects the fact that the petitioner, who had no attorney, was unable to present the court with an adequate analysis of the treaties. It could not be expected, of course, that the Tax Court, which normally does not interpret treaties, would have, on its own, any appreciable familiarity with the long and complex litigation involving the Stevens treaties. Consequently, although the court briefly alluded to the lower court decisions in United States v. Washington, it failed to even mention Fishing Vessel or any of the other Supreme Court decisions interpreting the treaties and also failed to demonstrate an understanding of the principles of those cases.

Further, the Tax Court, as might be expected, relied heavily on Strom, which is, in my view, no longer good law. The court also interpreted Capoeman as essentially limited to its facts, contrary to the interpretation given that case by the federal courts of appeal. *See* discussion, *supra*, at pp. 7-9. Evidently, it was this interpretation of *Capoeman* that led the court to conclude that because the petitioner's fishing rights were not individually owned in the sense an allotment is individually owned, there could be no tax exemption. The court cited *Fry*, *Anderson* and other cases discussed *supra* at pp. 7-9 as support for that interpretation, based on the holdings in those cases that, in the circumstances at issue, income earned by Indians from tribal land was not exempt. The basis for those decisions, however, as discussed above, was not that income from tribal property is *ipso facto* taxable, but that the General Allotment Act exemption did not apply and, second, that no other exemption could be found in treaty on statute. The second basis for those decisions makes them inapplicable to treaty fishing income, for which an exemption is found in the treaties. For these reasons, particularly the lack of treaty analysis, I do not consider the *Earl* decision authoritative.

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Valley
Medical
Center

July 21, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data-gathering and administrative burden on plan sponsors. Much, if not most of the data gathered is difficult to obtain and will not be used for any other purpose. Data-gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant. At our facility, we will have to hire someone with an appropriate background to do the data-gathering or testing, or use outside sourcing to get the task accomplished. Of course, it will be our patients who will pay for this through increased rates.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as they may be required under state and federal law. Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing are staggering.

In order to provide a measure of relief to plan sponsors- especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

-- Repealing Section 89;

-- Simplify the rules by establishing several safe harbor alternatives.

I do believe you should keep this proposed regulation in perspective by asking "What is it going to accomplish?" From my perspective, it is not going to result in any benefit to the payors of health care payors because 1) it simply adds costs to those plan sponsors who have never "discriminated", which is the group I feel Valley Medical Center falls into; or, 2) for a plan sponsor that doesn't meet the test for non-discrimination, it means probably a reallocation of existing plan costs, and more than likely an increased benefit cost to offset the reduced benefits for those effective. So, in the case where discrimination is found, the cost to the payor of health care services would probably increase more than where no discrimination was found, but in both instances, the cost of health care will increase at a time when we in the industry are confronted with other artificial inflation spiraling forces (e.g.: increased Medicare and Medicaid write-offs).

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Karen Hickey
Director of Human Resources

KH/fp

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July 20, 1988

Ms. Laura Wilcox
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Washington, DC 20510

Re: HR 4475 as a Possible Amendment to S 2238

Dear Ms. Wilcox:

In response to your request, I respectfully submit the following comments regarding the Technical Corrections Act of 1988 (Corrections Act).

I. Commenters.

These comments are made on behalf of Klawock Heenya Corporation, Cape Fox Corporation and Klukwan, Inc. (collectively, the "Village Corporations"), each of which is a Village Corporation organized pursuant to the Alaska Native Claims Settlement Act of 1971, as amended (ANCSA), 43 U.S.C. § 1601 et seq. Each of the Village Corporations is located in the Southeast Region of Alaska, is or has been engaged in the timber industry, and has entered into one or more sales of losses including net operating losses ("NOLs").

II. H.R. 4475 Would Repeal the NOL Provisions.

Current authority to sell NOLS is found at Section 60(b)(5) of the 1984 Tax Reform Act, as amended by Section 1804(e)(4) of the 1986 Tax Reform Act (the "NOL Provisions") and expires on December 31, 1991. H.R. 4475 would repeal the NOL Provisions prospectively by terminating the authority of an Alaska Native Corporation ("ANC" or "Native Corporation") to: (i) sell its NOLs which arise after April 26, 1988, to another corporation, and (ii) enter into any transaction to sell NOLS, whenever generated, after April 26, 1988. It is our understanding that H.R. 4475 is included as a provision of the House Technical Corrections bill (H.R. 4333).

III. Village Corporations' Position on H.R. 4475.

The Village Corporations would prefer that H.R. 4475 not be enacted or that its effective date be postponed. However, if Congress must modify or repeal the NOL Provisions as part of the Corrections Act, the Village Corporations urge that, at a minimum, the attached statutory and committee report language be included. The purpose for making these clarifications is to assure that Native Corporations obtain the full benefit of those NOL sales authorized by Congress and completed prior to April 27, 1988. Furthermore, such clarifications will enable the Native Corporations to avoid needless and unintended litigation either with the buyers of such losses and credits or with the Internal Revenue Service. Since the proposed changes would merely clarify existing law, and do not permit additional losses to be sold, they will not cause an unanticipated loss of revenue.

IV. Recommendations.

A. Legislative History.

The Village Corporations are concerned that if 1986 Reform Act § 1804(e)(4) is modified or repealed, such action may be accompanied by legislative history critical of completed transactions. Such a report would lend support to the IRS's position that many ANC NOLs sold prior to the modification or repeal provision's effective date should be disallowed--even if losses were generated and sold in a manner that complied with the Code. Representative Dan Rostenkowski's (D-IL) floor statement introducing H.R. 4475 makes clear his intention that repeal of the NOL Provisions be prospective and "not affect losses transferred in taxable years prior to the date of introduction." 134 Cong Rec H. 2626 (daily ed April 27, 1988). The Village Corporations urge that the provisions of the Corrections Act be consistent with this intent.

B. Carryback of Losses.

As proposed, H.R. 4475 repeals the authority of Native Corporations to sell NOL arising after April 26, 1988. As a result, NOL incurred by a Native Corporation between April 27, 1988 and December 31, 1991 could not be carried back to offset the pre-April 27, 1988 income generated on the consolidated federal income tax return of a Native Corporation.

It is the Village Corporations' position that no provision of the Corrections Act should preclude an ANC from carrying-back losses that arise after April 26, 1988 to offset pre-April 27, 1988 income generated in the consolidated return of a Native Corporation. Such transactions were entered into in good faith compliance with existing law. Thus, after the effective date of any ANC NOL modification or repeal Corrections Act provisions, a carryback could be used, for example, to "fill in" for ANC losses sold in a pre-effective date transaction which are subsequently disallowed by the Internal Revenue Service on audit. In this way, the Natives would receive the full benefit of their pre-effective date transactions.

C. Audit Procedures.

The Internal Revenue Service has ruled that an ANC NOL buyer's income may be consolidated with a Native Corporation's only to the extent necessary to fully utilize the Native Corporation's losses and credits, as determined on audit. If the Native Corporation's losses are reduced on audit, no tax would be due from the Native Corporation because an equal amount of the buyer's income (previously reported on the Native Corporation's consolidated federal income tax return) would "spring back" to the buyer. Accordingly, any corresponding income tax deficiency would appear on the federal income tax return of the buyer. Only the buyer, not the Native Corporation, would receive a "Notice of Proposed Deficiency" from the Internal Revenue Service. Without receipt of a "Notice of Proposed Deficiency," the Native Corporation could not obtain standing in U.S. Tax Court. Similarly, if it owes no tax, the Native Corporation could not sue for a refund in a U.S. District or Claims Court.

Because the Native Corporation receives most of the benefit of a NOL transaction, the buyer has less at stake during audit and, therefore, less incentive to substantiate the losses and credits at audit. Furthermore, the buyer often has less immediate access to information necessary to substantiate those losses or credits and may be preoccupied with other items on its return. As a consequence, there is a risk that the transaction's benefits to the Native Corporation may be diluted or reduced.

The Village Corporations propose that any modification or repeal of the NOL Provisions include language requiring that the Internal Revenue Service issue a Notice of Proposed Deficiency to both the ANC NOL buyer and the Native Corporation seller. In this way, either party to the transaction will be able to obtain jurisdiction in U.S. Tax Court.

D. Alternative Corporate Minimum Tax.

Under current law, NOL sale payments to Native Corporations are not subject to regular corporate income tax. In prior Internal Revenue Service administrative rulings, these payments have also been judged to be exempt from the alternative corporate minimum tax.

The Village Corporations' propose that these administrative rulings be codified to assure that those payments received by Native Corporations for sales completed prior to April 27, 1988 not be subject to any form of federal taxation, including the alternative corporate minimum tax.

V. The ANCSA Experience Before the NOL Provisions.

Pursuant to ANCSA, Congress transferred to the Alaska Native Corporations the right to select 44 million acres of land from the federal government, and also transferred $962.5 million to the Alaska Native Fund (ANF) for disbursement to the Native Corporations over a ten year period. In return, the Alaska Natives relinquished all of their Alaskan aboriginal rights. The land was to be conveyed to the Natives within three years of the Act's 1971 enactment, and the ANF payments were to be used solely for corporate capital needs. Under Section 2 of ANCSA, Congress declared its express intent that "the settlement should be accomplished rapidly, with certainty, in conformity with the real economic and social needs of Natives, without litigation, with maximum participation by Natives in decisions affecting their rights and property ... [and] without creating a reservation or lengthy wardship or trusteeship."[1]

Unfortunately, the Natives actual experience with ANCSA has been quite different. The Native Corporations were forced to expend ANF monies and even shareholders' personal savings to obtain the benefits the settlement was supposed to grant them. In fact, to this day, many Native Corporations--including all of the Village Corporations--have yet to receive all of their land under ANCSA.

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[1] ANCSA Section 2(b), 43 USC Section 1601(b) (1971).

Ambiguities in ANCSA, which Congress has needed to clarify on numerous occasions, have led to further delay, confusion and litigation. In obtaining their land, the Village Corporations have had to contend with the competing claims and positions of the State of Alaska, boroughs and municipalities, federal agencies, environmentalists, neighboring villages and regional corporations, and individuals such as homesteaders.

The most egregious period of delay, from 1971 until at least 1980 was, ironically, also a period of historically high inflation. Native Fund payments, however, were not adjusted for inflation and did not bear interest. This resulted in a massive reduction in the purchasing power of the cash settlement. When these factors are accounted for, it has been estimated that the actual value of the ANF to the Natives was about 55% of the $962.5 million originally transferred by the United States. As a result of these bureaucratic delays and economic conditions, when the Native Corporations finally did begin to receive their land, most were already in financial difficulty. The Native Fund that was intended by Congress to capitalize these corporations and exploit the land's natural resources had, instead, been eroded by inflation, market conditions and enormous unanticipated costs associated with obtaining title to the land. Thus, when the land was finally available, the Native Corporations were required to borrow venture capital, often with the land itself as security.

For the Village Corporations and other Native Corporations who received commercial timberland, an additional factor further eroded the value of the Settlement. Had the government conveyed the timberlands to the Native Corporations without undue delay, when Native Fund money was available to capitalize timber operations, Native Corporations would have had the opportunity to generate substantial profits marketing their timber in the high-priced timber market of the late 1970's. But because most Native Corporations did not receive their timberlands until after timber prices had peaked and the timber industry was in a severe and long decline, the Natives missed the opportunity to realize substantial profits from these lands. Since their shareholders economic survival depended on it, most Native Corporations, including the Village Corporations, had no choice other than to harvest the timber at a large loss. However, these tax losses were useless to the Natives unless they could sell them, since their chances for profitability--even during the 15 year period during which carryforward is allowed--were, at best, marginal.

This is the context in which first Section 60(b)(5) of the 1984 Reform Act and eventually Section 1804(e)(4) of the 1986 Reform Act were enacted.

VI. The NOL Provisions.

A. Section 60(b)(5) of the 1984 Reform Act.

Recognizing that the purposes for which ANCSA was enacted had not been met, Congress enacted tax legislation. Section 60(b)(5) of the 1984 Reform Act exempted Native Corporations from new general rules relating to the filing of a consolidated federal corporate income tax return until 1992. Although this exception was intended to allow Native Corporations to use their losses against a profitable corporation's income in exchange for a tax sharing payment, inadequate legislative history accompanied the provision and impeded the ANCs' ability to convince profitable corporations to join in NOL transactions. Additionally, the Internal Revenue Service refused to rule on requests submitted by taxpayers that had structured such transactions, in part because other Sections of the Internal Revenue Code and principles of law outside of the consolidated return requirements generally preclude such types of transactions.

Section 60(b)(5) also created several inequities. Only a few Native Corporations could use the provision. A complete system of asset transfers, stock purchase and security agreements were also required. Section 60(b)(5) produced a benefit "split" between an ANC NOL buyer and seller that strongly favored the corporate buyer. This often left a profitable corporation with a large windfall while providing the Native Corporation with a small share of the tax benefit associated with the loss. In some cases under Section 60(b)(5), the Native Corporation received as little as 37 percent of the tax benefits from such sales.

B. Section 1804(e)(4) of the 1986 Reform Act.

In recognition of Section 60(b)(5)'s shortcomings, Congress enacted section 1804(e)(4) of the 1986 Reform Act. Among other things, Section 1804(e)(4) mandates that no Section of the Internal Revenue Code or principle of law shall deny the benefit or use of losses incurred by a Native Corporation to the affiliated group of which the ANC is the common parent.

During consideration of the 1986 Reform Act, Senator Ted Stevens (R-AK) offered this explanation of the Congressional policy behind Section 1804(e)(4):

> "In 1984 and again today, we are offering an amendment to further the purpose of the Alaska Native Claim Settlement Act. The amendment before us is necessary in order to offset some of the net operating losses that were caused by the delay of Congress in eliminating impediments to the distribution of land to the regional and village corporations pursuant to ANCSA.
>
> "This amendment allows a portion of the loss that was incurred as a result of the failure of the Federal government to live up to its commitment to the Natives to be absorbed in a tax transaction. The amendment is grounded in social policy, the policies of ANCSA, and not in tax policy considerations.
>
> "The Native Corporations were organized pursuant to the mandate of the 1971 Act. Alaska Natives operate these corporations pursuant to a mandate of Congress." 132 Cong Rec S. 8176 (daily ed. June 23, 1986).

Section 1804(e)(4) increased the Native Corporation's share of tax savings at the expense of buyers. It also increased the number of buyers of Native Corporation NOLs, allowing virtually every Native Corporation to sell its NOLs. Since the enactment of Section 1804(e)(4) Native Corporations have generally received NOL transaction payments equivalent to between 70 and 85 percent of a transaction's tax benefits.

VII. The NOL Provisions Have Been Successful.

The NOL Provisions reflect a commitment of Congress to preserve the settlement's value to the Natives by permitting them to sell their tax losses. The Provisions have had a significant positive effect on Native Corporations and their shareholders. Many corporations have been able to pay off burdensome debt. Others have been able to invest in businesses or other investments that should benefit their shareholders in the coming years. Still others have finally been able to declare dividends to their shareholders.

This is exactly what Congress intended that the Native Corporations do with the money provided by NOL sales. But these gains will be diminished if Congress encourages the Internal Revenue Service and the courts to adopt the position that the NOL Provisions were a mistake and disallow completed transactions.

VIII. Requested Action By The Committee.

If Section 1804(e)(4) of the 1986 Reform Act is to be modified or repealed in the Corrections Act, the Village Corporations believe that Native Corporations should receive the full benefit of any pre-effective date NOL sale authorized by current law. Accordingly, while additional transitional or other relief may be appropriate and necessary, at a minimum, the Village Corporations respectfully request that the attached statutory and report language be included by the committee in any modifications to or repeal of the NOL Provisions.

IX. No Effect On Revenue.

Because these amendments do not apply to any ANC NOL sale transactions that occur after April 26, 1988, the effective date of H.R. 4475, they will not cause an unanticipated loss of revenue.

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Savings Bank

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July 25, 1988

Laura Wilcox
Hearing Administrator
US Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, DC 20510

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses--at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resulting Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternative coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization--as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex--yet, as the effective date draws closer, we are still lacking the necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors--especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards--you should consider the following alternatives:

- Repealing Section 89
- Delaying Section 89's effective data to at least a year after Treasury issues final regulations
- Simplifying the rules by establishing several safe harbor alternatives

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Jean D. Racine

Jean D. Racine
Vice President
Administration

WELLS FARGO BANK

STEPHEN A. ENNA
Senior Vice President

525 Market Street
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August 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington D.C. 20510

Dear Ms. Wilcox:

The new IRS Section 89, enacted as part of the Tax Reform Act of 1986, applies detailed nondiscrimination rules to employer sponsored benefit plans, including group health and group term life arrangements. While Wells Fargo fully supports Congress' goal of preventing discrimination in employer provided health and group-term life benefits, Section 89 institutes a complex web of administrative requirements exceeding the capabilities of many employers. In addition, although Section 89 is scheduled to take effect for many employers beginning January 1, 1989 there are still no regulations on many critical Section 89 issues.

Although a technical correction has been proposed to delay the effective date of one aspect of the Section 89 rules, this provision is insufficient. Unless Congress acts, the complexity and lack of timely regulatory guidance may result in less benefits to the very workers Section 89 seeks to protect.

Again, we fully support Congress' goal of preventing discrimination in employer provided benefits, but two things are critically needed:

- Simplification
- A minimum of 12 months lead time following issuance, in final form, of all regulations needed to apply section 89

We urge Congress to use this delay to enact major simplifying changes to Section 89. Unless compliance is simplified employers will be discouraged from offering benefits that in any way complicate or add extra steps the Section 89 testing process. Employers will be driven to simplify their plans undesirably, for example, by reducing available health options (including HMOs) and eliminating cafeteria plan choices. We would be pleased to assist Congress in developing reasonable and practical revisions to Section 89.

Sincerely

Plan Administrator
& Personnel Director

Whidbey General Hospital
P.O. Box 400 • Coupeville, Washington 98239-0400 • Tel. (206) 678-5151

July 20, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
SSD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Members of the Senate Finance Committee:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data-gathering and administrative burden on plan sponsors. Much, if not most of the data required is difficult to obtain and will not be used for any other purpose. Data-gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination? While there is a slightly easier "alternate coverage test" because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a health maintenance organization - as they may be required under state and federal law. Is it fair to penalize employers who wish to provide employees, with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing are staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsor - especially those plan sponsors who have never "discriminated" but are now in a position where they have to prove their non-discrimination according to nearly incomprehensible standards, you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective date to at least a year after Treasury issues final regulations;
- Simplify the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Robert L Zylstra

Robert L. Zylstra
Administrator

The
WILLIAM C. EARHART
Company, Inc.
ADMINISTRATORS OF EMPLOYEE BENEFIT PLANS
P O BOX 4148 · PORTLAND OREGON 97208 · AREA CODE 503-282-5581 · OFFICES: 3140 N E BROADWAY OR TEAMSTERS BLDG

August 3, 1988

Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

RE: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Dear Ms. Wilcox:

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses - at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable up to a point. It is difficult to fully subscribe to what appears to be the intent of Congress that a 17 1/2 hour per week employee should have somewhat the same benefits as a "highly compensated employee". However, the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such complicated and detailed methods to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailabe to employers who offer both a traditional health plan and a Health Maintenance Organization - as may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex - yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

In order to provide a measure of relief to plan sponsors - especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards - you should consider the following alternatives:

1. Repealing Section 89;
2. Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
3. Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

William C Earhart

William C. Earhart, President
The William C. Earhart Co., Inc.

July 25, 1988

Ms. Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D. C. 20510

Dear Ms. Wilcox:

Re: Comments for the Record
July 13, 1988 Hearing on Technical Corrections
IRC Section 89

Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986, places an overwhelming data gathering and administrative burden on plan sponsors. Much, if not most, of the data required is difficult to obtain and will not be used for any other purpose. Data gathering and testing will also lead to large expenses -- at a time when many employers are already finding the cost of health care to be exorbitant.

The concept of non-discrimination is laudable, but the resultant Section 89 non-discrimination rules are overwhelming. Is it really necessary to use such a complicated and detailed method to prove non-discrimination?

While there is a slightly easier "alternate coverage test," because of the way the test is designed, it will not be available to any but the plan sponsor with the simplest plan. Indeed, it will be unavailable to employers who offer both a traditional health plan and a Health Maintenance Organization -- as they may be required under state and federal law.

Is it fair to penalize employers who wish to provide employees with a choice among benefits? Even assuming that a plan is non-discriminatory, the cost of gathering and maintaining data, as well as actual testing, is staggering.

The rules are incredibly complex -- yet, as the effective date draws nearer, we are still lacking necessary Treasury regulations. How can employers be expected to comply when we have not received any meaningful guidance on the many outstanding issues? Even if regulations are issued in the near future, there will not be sufficient time to respond to the new requirements before the rules will be effective.

your
Good Healthkeepers® 1500 Division Street, Oregon City, Oregon 97045 (503) 656-1631

In order to provide a measure of relief to plan sponsors -- especially those plan sponsors who have never "discriminated" but who are now in a position where they have to provide their non-discrimination according to nearly incomprehensible standards -- you should consider the following alternatives:

- Repealing Section 89;
- Delaying Section 89's effective data to at least a year after Treasury issues final regulations;
- Simplifying the rules by establishing several safe harbor alternatives.

Your consideration of these issues and the plight of plan sponsors is appreciated.

Sincerely,

Robert A. Steed

Robert A. Steed
Administrator

[illegible]

August 5, 1988

Laura Wilcox, Hearing Administrator
U.S. Senate Committee on Finance
SD-205, Dirksen Senate Office Building
Washington, D.C. 20510

Ms. Wilcox:

We are deeply concerned about the tremendous data assemblage and administrative burden created by Section 89 of the Internal Revenue Code, added by the Tax Reform Act of 1986. Why? Why? Why?

First, small businesses are hurt by Section 89. We are a relatively small company (less than 400 employees) and have a small administrative staff. Further, we must maintain a "lean" organization to compete effectively in our markets. Section 89 will add significant costs with no productive outcome. We do not have the resources to absorb such costs.

Second, Section 89 will add costs to the already rising cost of health care. It will not result in non-HCE's receiving more benefits. Rather, it will result in HCE's receiving less benefits and it will also reduce the total benefits of all employees to offset the rise in administrative costs. Bluntly, Section 89 adds unnecessary costs and suffering to both employers and employees, particularly small businesses like ours.

Compliance with Section 89 will be a nightmare. We strongly advocate the repeal of Section 89. In the meantime, we urge a prudent approach by your committee in reducing the complexity and burden of compliance, particularly for small businesses.

Cordially,

WILLIAMS' BAKERY

S J Mayer

Steven J. Mayer
Vice President, Human Resources

cc: Senator Hatfield
Senator Packwood

Squire, Sanders & Dempsey

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Statement on the Technical Corrections Act of 1988
(H.R. 4333 and S. 2238)

This statement describes a technical problem arising out of the generic transition rules of the Tax Reform Act of 1986 (the "Act") that would prevent the tax-exempt financing of certain pollution control facilities consisting of a cooling tower and related facilities at the Wm. H. Zimmer Generating Station (the "Zimmer Facilities"). The Zimmer Facilities are owned as tenants in common by The Cincinnati Gas & Electric Company, Columbus Southern Power Company and The Dayton Power and Light Company (the "Companies"), and the financeable cost is not currently expected to exceed $120 million. Squire, Sanders & Dempsey has been retained by the Companies, and this statement is being submitted on their behalf.

The problem involves the imposition of a pre-September 26, 1985 "inducement resolution or other comparable preliminary approval" requirement by Section 1312(a)(1)(B) of the Act to the tax-exempt financing of a facility that commenced construction before September 2, 1972 and that will be completed on or after September 26, 1985. This matter is not addressed in the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) as originally introduced. The following review of the existing Treasury Regulations containing the official action or inducement resolution requirement and the history of Section 1312 of the Act, as they affect the Zimmer Facilities, indicates why this correction is appropriate. Because the facts giving rise to this problem are rather unique, it is believed that there are no other similarly affected facilities. Therefore, the suggested correction would have a very limited impact.

Under Treas. Reg. §1.103-8(a)(5)(ii), copy attached, an exempt facility which commenced construction, reconstruction or acquisition before September 2, 1972, could satisfy certain applicable timing requirements if an appropriate official action or inducement resolution was adopted before the facility was placed in service. Under this rule, a facility where construction was commenced before September 2, 1972 and was completed on or after September 26, 1985 could satisfy Treas. Reg. §1.103-8(a)(5)(ii) if an appropriate official action or inducement resolution was adopted on or after September 26, 1985 but before the facility was placed in service.

On September 26, 1985 the Joint Committee on Taxation released a summary of tax reform options which included provisions to change certain rules applicable to tax-exempt financing of certain exempt facilities such as the Zimmer Facilities. These provisions had an effective date of December 31, 1985 with a transition rule exception allowing tax-exempt financing after that date for certain of these facilities where construction was commenced before September 26, 1985 and was completed on or after that date. The proposed transition rule contained an additional requirement that "[f]acilities would be defined as property for which bond financing was approved by a governmental unit . . . before September 26, 1985." H.R. 3838 as passed by the House of Representatives in December 1985 contained a transition rule exception (including a pre-September 26, 1985 inducement resolution requirement) similar to that set forth in the earlier Joint Committee statement. H.R. 3838 as passed by the Senate in June 1986 contained a parallel transition rule exception but substituted "March 1, 1986" for "September 26, 1985." The Conference Committee version of H.R. 3838 adopted the House transition rule on this point so that Section 1312(a)(1)(B) of the Act, as enacted into law in October 1986, contained a pre-September 26, 1985 inducement requirement. Significantly, there is no indication in the legislative history of the Act that Congress intended to repeal Treas. Reg. §1.103-8(a)(5)(ii) with the enactment of Section 1312(a)(1)(B) of the Act.

The construction of the Zimmer Facilities began before September 2, 1972 and they have not yet been placed in service. Thus, under the existing Treasury Regulations, the Zimmer Facilities could meet the timing requirements for tax-exempt financing as long as an "inducement resolution" was obtained before the placement in service date. On the other hand, the generic transition rule of Section 1312(a)(1)(B) of the Act requires adoption of an inducement resolution with respect to the Zimmer Facilities before September 26, 1985. The generating facility served by the Zimmer Facilities was originally planned as a nuclear power plant. The construction of the nuclear plant was not completed, and in 1984 the Companies decided to convert the partially constructed plant to a coal-fired facility. In November 1984 the Companies obtained an inducement resolution with respect to the yet-to-be constructed pollution control facilities for the coal-fired facility. However, in reliance on the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii), the Zimmer Facilities were not expressly described in that inducement resolution. In response to the new requirement of Section 1312(a)(1)(B), an amended inducement resolution specifically referring to the Zimmer Facilities was obtained on November 7, 1985, and consequently the Zimmer Facilities have now clearly satisfied Treas. Reg. §1.103-8(a)(5)(ii). Moreover, the Zimmer Facilities would have satisfied the Senate transition rule based on a March 1, 1986 date but do not satisfy the transition rule of the Act based on a September 26, 1985 date.

The unfairness caused by Section 1312(a)(1)(B) of the Act in this case is due to the fact that the new inducement resolution rule was first made public on September 26, 1985, and as a result it became effective immediately, even though under then existing law no such requirement applied to the Zimmer Facilities. It is particularly inequitable to deny tax-exempt financing of the Zimmer Facilities where tax-exempt financing had been contemplated by the Companies well before September 26, 1985, but where an inducement resolution had not been obtained as of that date in reliance on the existing Treasury Regulations.

The foregoing circumstances involve a case where Congress should make a technical correction to the Act that would permit tax-exempt financing on a transition rule basis of a project, such as the Zimmer Facilities, where construction had commenced before September 2, 1972 and was still ongoing on September 26, 1985 and where an inducement resolution was obtained after September 26, 1985. An appropriate technical correction would be one that applied for purposes of Section 1312 of the Act the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii). The following language, added to either Section 1312 or Section 1318 of the Act, would accomplish this purpose:

> In the case of a facility the construction, reconstruction or acquisition of which commenced before September 2, 1972, the requirement of subsection 1312(a)(1)(B) shall be satisfied if an inducement resolution or other comparable preliminary approval is adopted by an issuing authority (or by voter referendum) before the date the entire facility is or was first placed in service.

Because Section 1318 contains a number of special rules relating to effective dates and transition rules, it is probably more appropriate to make this correction in Section 1318.

Thank you for your consideration of this matter.

Respectfully submitted,

Jackson B Browning, Jr

Jackson B. Browning, Jr.